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ECONOMIC SUMMIT, LATIN DEBT AND THE BAKER PLAN

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TUESDAY, MAY 20, 1986

U.S. SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, DC.

The committee met at 9:35 a.m., in room SD-419, Dirksen Senate Office Building, Hon. Richard G. Lugar (chairman of the committee) presiding.

Present: Senators Lugar, Kassebaum, Evans, Pell, Cranston, Dodd, and Kerry.

The CHAIRMAN. This hearing of the Senate Foreign Relations Committee is called to order.

Mr. Secretary, we welcome you to the Committee on Foreign Relations today, and we look forward to hearing from you with respect to a number of interesting and important international economic issues.

I want to say at the outset of this hearing that the President and you, as his principal economic adviser, are certainly to be congratulated on a series of initiatives taken by the United States in recent months in response to global economic problems.

The Plaza Hotel Agreement on exchange rates, the Baker plan for debtor nations and the cluster of agreements arising out of the Tokyo Summit all are testimony to a creative and activist U.S. international economic policy.

Problems of exchange rates, debt, economic coordination, and reduction of barriers to world trade do not invite quick solutions.

Our dialog this morning, therefore, is in the nature of stock taking on issues which affect not only the economics but the political well-being of nations around the globe.

Americans should be under no illusion that we can evade these issues. This committee has, in recent days, looked at the specific problems of Mexico. But Mexico's problems, which are directly affected by economic forces outside the borders of this Nation, also have their impact on the lives of Americans.

Our exports are adversely affected by Mexican economic problems and our difficulties with illegal immigration are made worse by unemployed Mexicans seeking jobs in this country.

You, Mr. Secretary, have seen clearly that we had better be active players in international economic games because our interests will be affected whether we are in them or not.

We, therefore, appreciate your willingness to meet with us.

I would note for the benefit of my colleagues that you must leave here shortly before the hour of 11:15 for a meeting with President Reagan.

I would like to call now upon the distinguished ranking member, Senator Pell, for his opening statement.

Senator PELL. Thank you, Mr. Chairman.

I join with you in welcoming Secretary of the Treasury James Baker.

Our committee does not often have an opportunity to receive testimony or ask questions of the Secretary of the Treasury as he spends more time before other committees, as is consistent with his responsibilities. Therefore, I hope the Secretary will understand if the questions this morning are far ranging, as we make the most of our opportunity to talk with him.

I believe that Secretary Baker deserves praise, too, for the leadership role he has played in the formulation of international economic policy with our allies. First, his successful effort to reach agreement among our closest allies in a program for reducing the value of the dollar last September, and then later, in the fall, his presentation of a plan for coming to grips with the systemic problems created by the massive external debt obligations of developing countries are very good examples of his leadership.

From press reports I have read, it looks as though the Tokyo Summit also went well with respect to furthering your earlier efforts, Mr. Secretary, to work for better international economic policy cooperation between our Nation and our closest allies.

I must say, too, that this is a welcome change from what I feared was almost a neoisolationist policy, which was being pursued in the early days of the administration. The United States has historically been in the forefront of economic and foreign policy leadership, and I believe that other nations were really very troubled when we appeared, at first, to be stepping back from many of the multilateral institutions, such as the IMF and the World Bank, which we, the United States, had taken the lead in creating.

I look forward to hearing the Secretary's views, and I apologize to him because I have a markup in another committee that I have to leave for shortly.

The CHAIRMAN. Thank you very much, Senator Pell.

We will now receive an opening statement for the record by Senator Murkowski.

[The statement referred to follows:]

OPENING STATEMENT OF SENATOR MURKOWSKI

Senator MURKOWSKI. I would like to thank Secretary Baker for testifying before the Senate Foreign Relations Committee concerning his plan for dealing with the LDC debt crisis and to follow up previous administration testimony on economic conditions in Mexico.

In 1982, Mexico faced a financial crisis and an administration team led by the Treasury Department used the exchange stability fund to assist Mexico. Recently the Foreign Relations Committee heard testimony to the effect that economic conditions in Mexico are once again deteriorating. Last week, Customs Commissioner

William von Raab performed a great public service by explaining to the Western Hemisphere Subcommittee the extent of money laundering by U.S. banks of drug trafficking receipts from Mexico. The Customs Service is an arm of the Treasury Department and Secretary Baker is to be commended for the fine work of his subordinate. It is my intent to follow up on this matter by exploring the influence of another agency within the Department of Treasury, the Comptroller of the Currency, on money laundering by U.S. banks. If the United States is again asked to assist Mexico, responsiveness by the Congress will depend in large measure on how Mexico addresses United States concerns in this area.

The CHAIRMAN. Secretary Baker, we await your testimony.

STATEMENT OF HON. JAMES A. BAKER III, SECRETARY OF THE TREASURY

Secretary BAKER. Thank you very much, Mr. Chairman. I am delighted to have the opportunity to be here this morning to brief you on the principal economic developments at the Tokyo Summit, to bring you up to date on progress in implementing our international debt strategy, and to urge this committee's support for legislation authorizing participation by the United States in the Multilateral Investment Guarantee Agency.

I have a written statement which I would ask be inserted in the record, and if it is all right with you, I will summarize it.

The CHAIRMAN. Without objection, it is so ordered.

Secretary BAKER. Before turning to the specific subjects which I mentioned, allow me, Mr. Chairman, to describe the significant progress being made in establishing the fundamental conditions necessary to achieve and maintain a sound and growing world economy, more balanced trade positions, and greater exchange rate stability.

The Plaza Agreement of last September, to which you alluded and to which Senator Pell alluded, last September, has resulted in exchange rate relationships that better reflect underlying economic conditions.

The Plaza Agreement also contributed to movement toward stronger, more balanced growth among the major industrialized countries.

Inflation has been cut sharply, and is expected to stay low. This, of course, has facilitated a substantial reduction in interest rates and enhances prospects for further declines.

The deterioration in our trade position will be halted this year and we look forward to substantial improvement next year.

Preparations are well advanced for launching the new round of multilateral trade negotiations and, as I will detail later, our proposals for improving growth in the debtor countries have gained wide support and are now being implemented.

The progress that has been achieved in the general economic environment provides a golden opportunity to resolve our remaining problems. At the Tokyo Summit, President Reagan and the heads of the other major Free World democracies manifested the political will and leadership to confront the tasks that remain.

The Plaza Agreement and subsequent coordinated interest rate reductions evidenced the willingness, I think, and the ability of the major industrial countries to cooperate more closely on their economic policies. At the same time, experience of the past year demonstrated that exchange rate changes alone could not be relied upon to achieve the full magnitude of adjustments required in external positions.

It has become increasingly apparent that closer coordination of economic policies will be required. For this purpose, we went to Tokyo seeking to build upon the framework embodied in the Plaza Hotel Agreement. I think that we succeeded.

The arrangements that were adopted involve a significant strengthening of international economic policy coordination. Details of the new procedures will, of course, have to be worked out in subsequent discussions among the countries involved. However, I see the enhanced surveillance process working as follows:

First, the measures for use in assessing country goals and performance will be agreed upon by the countries participating in the enhanced surveillance process, utilizing the broad range of indicators stated in the Tokyo communique. These indicators would include growth rates, inflation rates, unemployment rates, fiscal deficits, current account and trade balances, interest rates, monetary growth rates, reserves, and exchange rates.

Second, each country will set forth its economic forecasts and objectives, taking into account these indicators.

Third, the group would review, with the managing director of the International Monetary Fund, each country's forecasts to assess consistency, both internally and among countries.

Fourth, in the event of significant deviations in economic performance from an intended course, the group will use its best efforts to reach understandings on appropriate remedial measures, focusing first and foremost on underlying policy fundamentals. Intervention in exchange markets could also occur when, to do so, would be helpful.

What is new in the arrangements adopted in Tokyo is that the major industrial countries have agreed that their economic forecasts, and objectives, will be specified taking into account, a broad range of indicators, and their internal consistency and external compatibility will be assessed. Moreover, if there are inconsistencies, efforts will be made to achieve necessary adjustments, so that the forecasts and objectives of the key currency countries will better mesh. Finally, if economic performance falls short of an intended course, it is explicitly agreed that countries will use their best efforts to reach understandings, regarding appropriate corrective action.

In sum, Mr. Chairman, we have agreed on a more systematic approach to international economic policy coordination, that incorporates a strengthened commitment to adjust economic policies. I am hopeful that the spirit of cooperation that made this agreement possible will carry over to its implementation. If so, we can look forward to greater exchange rate stability, enhanced prospects for growth, and more sustainable patterns of international trade.

Action toward closer coordination of international economic policies and greater exchange rate stability, complements our efforts to

promote a fair and, at the same time, open international trading system.

President Reagan and the others at the Tokyo Economic Summit reaffirmed their commitment to fighting protectionism, and strengthening the international trading system. They pledged to work at the September GATT Ministerial Meeting, to make decisive progress in launching the new round of multilateral trade negotiations, that will notably be seeking new GATT rules covering services, intellectual property protection and international investment, as well as improved market access abroad. We expect this meeting will initiate these important negotiations.

Our position on trade issues at the Tokyo Summit reflects the administration's commitment to maintaining an open U.S. market and ensuring a free, but fair, international trading system. We must avoid passage of protectionist trade legislation that would alienate our trading partners, encourage them to enact similar protectionist policies, and undermine the administration's international economic policy.

The resolution of international debt problems is important to the U.S. economy as a whole, as well as to our international trade and financial system. We also have strong political, and humanitarian interests, in improving economic growth and political stability in the debtor nations.

When I briefed this committee last October on our proposals for strengthening the international debt strategy, I warned that there are no easy solutions to the debt problem, and that the road ahead would be difficult and challenging. Seven months later, that statement remains valid. But I can also assure you that the directions in which we turned last fall, are still correct and that we are making progress in implementing our initiative.

In Tokyo, the summit leaders welcomed the progress made in developing the cooperative debt strategy, in particular building on the United States initiative. The U.S. Program for Sustained Growth has also received strong support from the international financial institutions, national banking groups in all the major creditor countries, as well as the key IMF and World Bank committees representing both debtor and creditor countries, and the OECD Ministerial.

As you know, the Program for Sustained Growth for the major debtor nations, proposed by the United States in Seoul was premised on credible, growth-oriented economic reforms by the debtor nations, supported by increased external financing.

Required policy changes in the debtor nations will take time to put into place and should not be expected to occur overnight. The process of implementing these reforms will also be much less public than the series of announcements to date, supporting the debt initiative. Implementation will take place through individual debtors' negotiations with the IMF, the World Bank, and the commercial banks.

This process is already underway. The IMF, for example, has existing or pending arrangements, with 11 of the 15 major debtor nations. The World Bank is also moving ahead to strengthen procedures, and policies, to implement its expanded role in the debt strategy. It currently has structural or sector loan negotiations un-

derway with 13 of the heavily indebted, middle income debtors. New structural or sectoral adjustment loans have already been signed with some of these countries, including Equador and Argentina.

The Program for Sustained Growth is important because it touches on a wide range of U.S. interests, but paramount among these is its importance for U.S. trade. Our exports to the major debtor nations—which have already increased by 18 percent, or $4 billion, during the past 2 years—can be expected to improve further in response to both recent exchange rate changes and stronger growth in the debtor economies as they adopt domestic economic reforms. It will also be important, however, for the United States and other industrial nations to maintain open markets for LDC exports.

We believe prompt enactment of legislation enabling U.S. participation in the Multilateral Investment Guarantee Agency, or MIGA, would make an important contribution to the implementation of our international debt strategy.

The United States has long been an advocate of a greater role for foreign direct investment in the development process. The MIGA will stimulate these flows and in addition, because of its multilateral nature, will be well positioned to promote investment policy reforms in developing countries. As the largest direct investor in other countries, it is in our best interest to see that appropriate investment protection standards are more widely accepted.

The administration thus strongly supports U.S. membership in the Multilateral Investment Guarantee Agency. The $222 million U.S. subscription to the MIGA involves only a $22 million budget outlay to be paid in cash. The potential return on this small investment is, however, substantial. As the MIGA stimulates private investment flows to LDC's, this additional capital can, over time, substitute for scarce official flows from both governments and the multilateral development institutions.

We should not allow delay in acting on the MIGA legislation to weaken the impetus behind MIGA. Many countries are moving expeditiously to take the necessary steps to join the agency. The United States, which has been a strong advocate of the MIGA and has taken an active role in ensuring that the agency created will be a sound and a credible one, should now also take the steps necessary to join this important institution.

Mr. Chairman, the problems still with us in the international economic arena are substantial and difficult. But we now have the most favorable general economic environment in many years for making further large strides toward resolving these problems. The United States is leading the way in devising solutions in the best interests of both our own country and the community of nations. We believe the comprehensive, growth-oriented approach we have urged is the preferred path, and we are making real progress in implementing our strategy.

I hope for your support in our efforts.

Before concluding my prepared remarks for today, I would like to add a few words about replenishments for the multilateral development banks.

In conducting our replenishment negotiations, we have assumed that up to $1.4 billion would be available in the outyears to fund these replenishments. The amount maintains the budget authority level for the MDB's of previous years and reflects the impact of Gramm-Rudman-Hollings.

I want to emphasize the administration's commitment and full support for the MDB's. I recognize fully that even in the best of years supporting foreign assistance is never popular and that now, at a time of severe budget constraint, it will be even more difficult.

However, the MDB's are extremely cost effective from a U.S. budgetary perspective, providing up to $60 in lending for each dollar in U.S. budget authority. Moreover, the bulk of MDB lending goes to countries which are of high priority to the United States, including countries such as Argentina, Brazil, Korea, and Mexico, which did not receive any United States bilateral assistance. We cannot duplicate that kind of leverage on a bilateral basis.

Mr. Chairman, we need the MDB's as part of our international economic strategy. I strongly believe that if we do not support the MDB's now, we may have to resort to more costly measures later.

Thank you very much.

[The prepared statement of Secretary Baker appears in the appendix.]

The CHAIRMAN. Thank you very much, Secretary Baker, for your testimony and for your comprehensive statement.

We will ask that members confine their questions to a 10-minute time period in this first round as we proceed.

Mr. Secretary, your statement suggests that there have been positive signs with regard to the LDC debts. How do you respond, however, to the fact that economic growth remains stagnant in most of the debtor countries, that the level of indebtedness in most of them continues to rise, and that, despite the fact that you have offered a roadmap at Seoul and other forums as to how nations might go into this growth-oriented strategy, many have not sold State-operated businesses, for example, or adopted procedures that would give greater confidence to outside lenders, either Government or private? You have highlighted Equador and Argentina, countries that apparently are on a growth-oriented strategy and have been rewarded accordingly, but there are other countries that have not shown this kind of progress and that, cumulatively, seem to be producing higher and higher mountains of debt, even while the strategy proceeds. Can you comment on these contrasts?

Secretary BAKER. Mr. Chairman, I would agree with you that not all countries have opted to go the path of growth-oriented economic reforms. I would also, however, say that there are countries other than just Argentina and Ecuador that have. Uruguay, Colombia, and Morocco have all initiated reforms of one type or another, in addition to Argentina and Equador. The Philippines has suggested that it would be a prime candidate for the Program for Sustained Growth, and at least the rhetoric is what we would like to hear. Of course, the proof of the pudding is in the eating, and we will have to see whether or not the reforms actually take place.

We have had extensive meetings with the finance minister and Central Bank Governor of Mexico. I think it is fair to say that the Mexican Government understands realistically what is required.

But it is not always easy to implement the kinds of reforms about which we are speaking. It takes a great deal of political will and a fair amount of political adjustment.

I think that there are efforts being made. There is certainly more progress than just in the two countries, Mr. Chairman, which you mentioned.

This is a major problem which took 10 to 12 years to develop, and we are not going to get out of it in 1 year.

The CHAIRMAN. Let me follow up specifically on Mexico and the Philippines.

In the Mexican case, as you point out, there is an understanding of what is required.

How would you answer persons who would say that additional fresh money for Mexico, which may be required during this calendar year, will be offset by capital which still seems to flow out of Mexico in very large amounts? On a net basis, are we assured that on a net basis, moneys that are new and fresh are going to stay? If so, is there enough reform at this point in terms of the sale of the State-run industries or at least no allegations of malpractice in the use of funds to give you confidence in how we are proceeding there?

Secretary BAKER. Mr. Chairman, I think the Mexican Government understands very well that taking the easy course domestically might well result in an absence of new capital flows. It might not be sufficient to attract new capital flows.

I think, frankly, the first threshold that has to be crossed by any country seeking to adjust through the adoption of growth-oriented economic reforms is to reverse capital flight. Until capital flight is reversed, there won't be additional lending. As far as private sector lending is concerned, it simply will not take place.

With regard, for instance, to Mexico, there has not been additional lending. I believe that the Government of Mexico understands, realistically, what is required. But the fact remains that it is exceedingly politically difficult to attain.

The CHAIRMAN. Well, that is true. But this is already May, and you are right, the additional capital has not been forthcoming.

How will we know that capital flight has stopped? Are there indicators in our banking system that will give us that kind of confidence?

Secretary BAKER. Yes, sir. We can measure that.

There had been a cessation, for instance, when the Government of Argentina adopted the Austral Program and capital flight was reversed, in effect. We were able to estimate that both in Argentina and here. We should be able to estimate capital flight from Mexico, as well.

I might say this.

The Government of Mexico, as you know, is engaged in negotiations right now with the IMF on a standby program. They are talking to the World Bank about some structural adjustment measures. They have a proposal for privatization of a number of State-owned entities. The question is whether or not they are going to take the reforms far enough.

That will be the test of whether or not they are able to reverse capital flight and whether or not they are able to attract new private flows of capital.

The CHAIRMAN. Obviously, the answer to those questions is important to them. It is equally important to us.

Secretary BAKER. It is, indeed.

The CHAIRMAN. I suppose my own concern is that as the months go on and there has not been the kind of movement that is required, estimates keep mounting from $2 to $8 billion as to the amount of additional capital that Mexico will need to meet the fiscal gap, even in this year. That is a very sizable sum.

Secretary BAKER. Well, Mr. Chairman, our estimate is nowhere near $8 billion. Assuming an oil price of $15 per barrel, we think Mexico's situation is clearly manageable, with modest additional capital flows, something in the neighborhood of $2 to $2.5 billion in new lending.

The CHAIRMAN. $2 to $2½ billion will be required if oil is priced at $15 per barrel?

Secretary BAKER. If oil should stabilize somewhere close to the $15 level. Of course, as you know, the spot price here in the last day or so is somewhere around $17.

The CHAIRMAN. Let me ask this. In the case of the Philippines, as you have visited with Mr. Ongpin and others, what sort of program is realistic? Short of following the general Baker plan idea, in which all sorts of resources might come in to the country, from multinational and from our own foreign assistance, what do you think should be the course of action? In other words, what actions should the Philippines take that will lead to attracting the substantial amounts of capital that the new government obviously requires?

Secretary BAKER. Mr. Chairman, the Philippine Government is presently in the midst of discussions with the IMF, discussions involving certain structural reform measures. They are talking to some of the multilateral development banks, as well.

I would not want to prejudge those discussions by saying they ought to do X, Y, or Z. But I think the important thing to recognize is that they, themselves, have stepped forward and said they would like to implement the kind of growth-oriented economic reforms that we have been talking about in the Program for Sustained Growth.

They are in active discussions and negotiations with the IMF and the multilateral development banks about that.

The CHAIRMAN. Will we be in a position to endorse their success? In other words, do we have indicators that will show that they are moving in that growth-oriented direction so that we can take a leadership role in the multilateral development banks in support of their loans?

Secretary BAKER. Yes.

We would be in a position, once we saw the detailed outlines of a proposal or program, to judge whether or not we thought that was adequate and sufficient. We would vote accordingly in the multilateral institutions.

The CHAIRMAN. Is there evidence that capital flow has stopped going out of the Philippines and that a reversal has occurred?

Secretary BAKER. I'm sorry, Mr. Chairman. I did not hear you.

The CHAIRMAN. In terms of capital flow——

Secretary BAKER. Has there been a reversal of capital flight?

The CHAIRMAN. Yes.

Secretary BAKER. There has been a reversal of capital flight, Mr. Chairman, since the elections. But I cannot tell you to what extent. I cannot measure it for you.

The CHAIRMAN. Do we have monitors that will give us that information bit by bit?

Secretary BAKER. I think we could provide some information for you, yes, sir. And we would be glad to do so.

The CHAIRMAN. Surely the allegation has been that the previous government either encouraged, or at least tolerated, very substantial capital flight. In terms of this new plan that you are suggesting, the reversal of this trend is probably crucial to success, for the same reason you raised with respect to Mexico.

Secretary BAKER. With respect to any adjusting country, the first step that has to be taken is to secure the confidence of the citizens of that country in the economy. That is absolutely right.

I will be delighted to pull together some information for you.

The CHAIRMAN. If you could furnish some information for the record, we would appreciate it.

Secretary BAKER. Yes, sir.

[The information referred to follows:]

RESPONSES OF SECRETARY BAKER TO QUESTIONS ASKED BY SENATOR LUGAR

Question. Has there been any evidence of a reversal of capital flight in the Philippines? Will there be monitors that our government has that could give us that information bit by bit?

Answer. At this time, we have no direct, detailed evidence of a reversal of capital flight. However, since the Aquino Administration came to power, Philippine international reserves have increased and the exchange rate has strengthened. This may be due in part to a return of flight capital.

It should be possible to estimate the reflow of flight capital as detailed balance of payments statistics for 1986 are published (although a precise measurement is unlikely to be possible given the nature of the problem). Data on non-bank Philippine deposits in the United States, which will become available later this year, may also shed some light on the subject when interpreted in conjunction with the balance of payments data.

Preliminary indications are that international investors are taking a "wait and see" attitude toward the Philippines. The same probably applies to Filipinos with capital abroad. If the government successfully implements needed economic reforms, prospects appear favorable for increased capital inflows.

The CHAIRMAN. Senator Pell.

Senator PELL. Thank you, Mr. Chairman.

Mr. Secretary, our committee has pending before it legislation that would authorize our participation in the Multilateral Investment Guarantee Agency at a cost of about one-fifth of a billion dollars, or $222 million.

Isn't this Multilateral Investment Guarantee Agency basically a duplication of what OPIC is charged with doing?

What would be the difference between the two?

Secretary BAKER. Not really Senator Pell, because OPIC is a quasi-governmental agency of the United States. MIGA is a multilateral agency in which quite a few governments will participate, and which will be designed to encourage investment policy reforms

in the lesser developed countries. We will have more, if you will, "stroke" through MIGA to encourage reforms of investment policies in the debtor nations than we ever could through OPIC.

Senator PELL. But isn't this also part of the mission of OPIC?

Secretary BAKER. That is the mission of OPIC as a bilateral matter, yes sir. But we think that the Multilateral Investment Guarantee Agency would be far more effective because we will be collaborating with and cooperating with other members of MIGA to encourage those reforms, and doing so in a multilateral setting.

Senator PELL. But doesn't the administration also propose the privatization of OPIC, believing these functions can better be carried out in the private sector?

Secretary BAKER. That's correct, Senator Pell. But OPIC is more in the nature, frankly, of an agency that insures against expropriation and political risk and that sort of thing.

MIGA is far more than simply another insurance agency. It is an institution or an agency, if you will, that we think will be very successful in encouraging the reform of investment policies in the LDC's.

Senator PELL. I'm not sold on OPIC. In fact, I voted against it because I thought it did more to export jobs and therefore did not serve our national economies interests.

Will MIGA also be involved in any way in the financing and guaranteeing of overseas investments and also in the export of American jobs?

Secretary BAKER. Well, it will be involved in guaranteeing investments abroad, yes sir.

Senator PELL. Very much like OPIC.

Secretary BAKER. To that extent, it will be.

But it will be encouraging reform in these countries that would permit foreign direct investment.

We are talking about dealing with a major debt problem here. One way to deal with it is to encourage equity flows as opposed to debt flows. Surely, we have always had, as a part of our international economic policy in this country, the encouragement of foreign direct investment abroad. The United States is the biggest single foreign investor in other countries—U.S. businesses and U.S. investments.

So I think from that standpoint, it is very important to our international economic policy.

Senator PELL. But you do not see a certain contradiction here in privatizing OPIC while creating a new government agency in MIGA?

Secretary BAKER. I do not because of the multilateral distinction, Senator.

OPIC is a quasi-governmental agency, the functions of which, in the opinion of the administration, could be performed as well by the private sector in the United States, insuring U.S. risks in other countries.

MIGA is a collaborative organization made up of many, many countries that will, in addition to insuring those risks, encourage the reform of direct investment laws in countries that have restrictions against direct investment.

It is important to the health of the world's trading system. It is important, as I mentioned earlier, to the United States as the world's largest investor abroad.

Senator PELL. I do not mean to beat a dead horse, but it would seem to me that that is part of the mission of OPIC, although, as you point out, on a bilateral basis. But in return for its intervention in some factories, in some efforts, it would seek to secure an improvement in the investment policies of the developing nation.

Secretary BAKER. Well, if we are going to participate in a multilateral organization, we have to do so as a government. We cannot do so through the private sector.

We can perform many of the functions that OPIC performs as well through the private sector. It is more of an insurance agency than the MIGA will be. MIGA will be involved, as I mentioned earlier, in encouraging reforms of investment policies in these debtor countries.

Senator PELL. Congress has attempted, I think unsuccessfully, to put safeguards on OPIC to prevent the export or loss of jobs. Will there be efforts made to put the same kind of safeguards into MIGA?

Secretary BAKER. I think we would be entitled, as we are in other multilateral organizations, to vote with respect to the adoption of policies which we support. We would support policies which would be consistent with that.

Senator PELL. Thank you very much.

I have no further questions, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Pell.

Senator Kassebaum.

Senator KASSEBAUM. Thank you very much, Mr. Chairman.

Secretary Baker, cooperation of the commercial banks is essential to the success of the Baker plan, I would gather.

What progress has been made and what cooperation have you received since the announcement of the plan?

Secretary BAKER. Senator Kassebaum, U.S. banks holding 96 percent in aggregate principal amount of debt outstanding to the 15 nations referred to in the Program for Sustained Growth have indicated that they support the proposal and would be prepared to do their part, provided the other elements of the proposal fell into place.

As I indicated when I briefed this committee following the Seoul meeting, this is not a bank bailout proposal, and it is not an armtwisting exercise.

We think the banks will participate because they will find it in their self-interest to do so. They have some bad loans over there.

To the extent that they can get reforms in the debtor countries, they can improve those bad credits and perhaps turn them into better credits. But to get those reforms, they are going to have to assure the countries that adequate capital flows will be available to support those reforms.

I think we have been pleased with the support that we have gotten from the commercial banks. I think, as countries begin to adopt these reforms, you will see commercial banks making additional loans.

They are already, of course, participating in refinancings and that sort of thing.

Senator KASSEBAUM. Are these additional loans really essentially going to be used just to payoff the interest that is owed to them in the first place?

Secretary BAKER. They will be used to support the efforts of the debtor countries to adopt the growth-oriented type of economic reforms that we think they have to adopt if they are ever going to earn their way out of debt. And yes, some of it will be used to pay interest. No question about it.

Senator KASSEBAUM. It becomes somewhat a vicious cycle, though, doesn't it?

I would like your thoughts on the Joint Economic Committee study that has just come out with a headline in, I think, Saturday's paper: "Latin debt policy seen hurting factories and farms but aiding U.S. banks." The thrust of that, as you know, is that the funds go to pay interest rather than in some way being encouraged to be a part of investment.

It seems to me that we have to have in some way a thrust in that direction, or else we are not doing a lot to enable those countries with a high debt ratio to be able to stand reform.

It seems to me that it requires a more delicate balancing act than perhaps we have now.

Accompanying this was a chart that showed that in 1980, we had about a $5 billion trade surplus, and today—and you know this figure better than I—perhaps about a $15 billion minus figure. To work our way out of this, it seems to me it will require the banks to perhaps be able to workout some policy of lower interest or interest payments that would go into some investment pool or capital generating effort in the debt country.

Secretary BAKER. As for as lower interest is concerned, Senator, there have been instances recently—within the last year and a half to two years—where the banks have reduced their spreads over LIBOR considerably, down to the point where they are only a fraction above that rate in some of the major debtor countries. So there has been a significant reduction of spreads.

When we start talking about debt relief, interest rate relief, and lending below market, though, the net effect of that in every case is going to be that the debtor is cutoff from access to the private financial markets. The credit will dry up, and not just credit for bank loans, but trade credits and ordinary commercial credits will dry up. The private financial markets will consider that, to some extent, this is a default.

With respect to the JEC report, we disagree with it. We acknowledge the fact that there has been some import reduction in these countries as a consequence of having to service their debts. But we believe that if those countries had lost their access to the credit markets, the import reduction would have been even greater.

We think that loss of access to the markets would be the necessary consequence of these debt reduction schemes.

The only way, in our view, that these countries are going to make it is to reform their economic policies in such a way that they can earn and grow their way out of debt and pay these loans off. The minute you tell the banks that they have to lend below

cost—in the first place, we cannot do that in this country, as I know you appreciate—you are going to cut those countries off from access to the markets. And then their imports are going to shrink even further.

Senator KASSEBAUM. Many of the Latin American countries that I have visited with have mentioned our sugar quotas and the restraints to trade from the protective nature here, whether it is coffee, textiles, and the various concerns that we have as well as other trading nations. Have you addressed in any way commodity prices and protectionism, which seem to me key elements of this as well?

Secretary BAKER. You are absolutely right.

It is extremely important that we, as I mentioned in my statement, that we keep our markets open to the products of these countries. We are not proud in the least of our sugar program. As the President indicated when he signed the Farm Bill, that is one thing that he disagrees with substantially and strongly.

Senator KASSEBAUM. But it is there.

Secretary BAKER. It is there.

Senator KASSEBAUM. And we have to work with the reality of the situation that we are in.

Secretary BAKER. That's correct.

Of course, we would love to see it changed.

Senator KASSEBAUM. Has there been any effort on your part or on the part of the administration, a coordinated effort with Japan and the European countries in addressing protectionism in commodity prices, particularly as they relate to the debtor nations?

Secretary BAKER. I think one of the major accomplishments, Senator Kassebaum, of the summit was that for the first time, we were able to get agreement of all the summit countries to discuss the particular problem you are pinpointing.

There is an entire section in the Tokyo Communique discussing the problems presented by agricultural subsidies by the EC, the United States and other industrialized countries. Heretofore we have never been able to get that on the agenda for discussion.

We do not have a solution to the problem. But at least the countries are sitting down and talking about it now.

Senator KASSEBAUM. Let me conclude by saying that I am very supportive of the Baker initiative. I think it was a very wise and forward-thinking initiative.

I do think that it will require some sensitivity as to how far we can push reform in some countries, and a balancing there. I am thinking of the African nations as well as Latin American countries. The indebtedness in the Latin American countries is far greater, of course.

But you can push just so far and then you have political consequences. So, I suppose in many ways it is a balancing act. But it seems to me that the banks have to be involved as well.

Secretary BAKER. I quite agree with that, Senator.

It is a balancing act. I might suggest, however, that we are not talking about austerity measures for the most part. We are talking about growth-oriented economic reforms.

I understand why it might be a political problem for some countries to sell their parastatals, because they have big, entrenched

bureaucracies and a lot of people might lose their jobs if those State-owned institutions are conveyed to the private sector.

But that is a little different than calling upon a country to devalue its currency or do something like that.

So we are really not talking about the same types of austerity measures that we were talking about before in connection with IMF adjustment programs. This does not mean, as I indicated in my answer to the chairman's question, that it is not politically difficult for some of these countries to adopt the necessary reforms.

Senator KASSEBAUM. Thank you.

The CHAIRMAN. Thank you very much, Senator Kassebaum.

Senator Evans.

Senator EVANS. Thank you, Mr. Chairman.

I may want to come back to the line of questioning that Senator Kassebaum has suggested, but let me begin first with some other questions.

I understand that you have added Italy and Canada at their request to the group of five, now making a group of seven. I don't know if it stops there, or if we will be requested that it be a group of 9, or 11, or however many.

I am particularly interested in Canada.

It seems to me that currency changes in the last several months have gone a long way toward reducing some of our trade problems with Germany and Japan, particularly Japan. Almost none of that has happened in our relationship with Canada.

It seems to me that if that currency restructuring has a good end result in terms of our trade imbalances with Japan and Germany, very shortly we are going to find that Canada is our biggest problem in terms of imbalance.

Can you enlighten me at all on what chance there is of arriving at any different relationship between the Canadian and U.S. dollar? This is fundamentally the biggest problem we have now in terms of trade with Canada and trade conflicts which constantly arise.

Secretary BAKER. Senator Evans, I think one consequence of the creation of a group of seven—assuming that we are successful in getting the enhanced surveillance mechanism to work the way we think it can work and the way it should work—is that Canada and Italy, as well as the G–5 countries, are going to have to set forth their economic forecasts, taking into account the economic indicators that we mentioned in the Tokyo Communique, one of which is exchange rates.

When there is an imbalance between a country's exchange rate relationship with another country and its trade deficit or surplus, those things will be looked at and we will seek to make them compatible.

That is the way the exercise is intended to work.

It seems to me that one part of the price of admission for Canada is it is now going to have to participate in these exercises, and to the extent that there are imbalances, Canada will have to agree to do the same thing that the other countries have agreed to do, and that is use its best efforts to redress those imbalances.

I think it is significant from that respect.

Senator EVANS. Well, I think it is good to have them as part of the operation. But it seems to me, in reading as carefully as I can, the propositions that you set forward in your testimony, that a lot of it is jawboning, which may well be about as much as we can do, and it may well be important in terms of our relationships with countries. But you say, finally, that "if economic performance falls short of an intended course, it is explicitly agreed that countries will use their best efforts to reach understandings regarding appropriate corrective action." Does that also include us?

Secretary BAKER. Yes, sir.

Senator EVANS. So, if our economic projections do not meet the expectations we have in our current budget, which they may well not, then what are we obliged to do?

Secretary BAKER. Well, we would be obliged to seek to come to agreement with the other countries with respect to what actions specifically we should take to redress that.

Senator EVANS. What are those most likely to be?

Secretary BAKER. I think a good example is we have already undertaken in the course of the agreement at the Plaza Hotel to work on our fiscal deficit. That would clearly be one of them, I suppose, if we don't meet our estimates.

I say that in light of the numbers that were reported this morning on the first quarter's GNP, and it is looking better and better with respect to meeting our numbers.

Senator EVANS. Do you really think that overall we are going to meet the fiscal 1986 GNP projection?

Secretary BAKER. Well, the first quarter GNP was just revised upward this morning from 3.2 to 3.7 percent. So we are getting close.

Senator EVANS. We are getting close. But the first quarter of fiscal 1986 was pretty sorry.

We will have to have a burgeoning economy in the last couple of quarters to meet it.

Secretary BAKER. We are looking to that.

Senator EVANS. We are looking better, I agree.

Secretary BAKER. We are looking better. That is the only point I am making.

But to answer your question, it would be incumbent upon us to use our best efforts to try to agree with the other countries on what steps we ought to take.

Senator EVANS. Let me turn back to Canada because I really do think that may well turn out to be the biggest difficulty we have. If, in fact, the changes in currency relationships have their intended effect vis-a-vis our trade imbalance with Japan, with Germany, and with some of our other major trading partners, it is my understanding that Canada has had the same problems we have had over the last several years. In spite of the weakness of their dollar versus ours, they have seen a run-up of their dollar in comparison with Japan and others of their trading partners.

So they are sort of going in parallel with us. They are getting the benefit now of that rebalance. But it does not seem to make any difference in terms of the relationship between Canada and the United States.

Can you enlighten me as to what it would take on Canada's part to bring us back to closer balance in terms of our dollar relationship.

Secretary BAKER. In terms of our dollar relationship——

Senator EVANS. Yes.

Secretary BAKER [continuing]. Or in terms of our trade relationship?

Senator EVANS. Well, I think they follow in parallel, don't they?

Secretary BAKER. Their currency has basically followed ours in terms of——

Senator EVANS. Other nations.

Secretary BAKER [continuing]. Yes, other nations.

Senator EVANS. But I am talking about the relationship between us now.

You know, I enthusiastically support the administration and the President in their views on trade. I think the protectionist sentiments that we are seeing in Congress are entirely wrong. But we have a lot of pressures, of course, at the moment. In my part of the country, it is on timber, where it is primarily a United States-Canada problem. I do not think there is any question that the exacerbation in timber has followed precisely the decline of the Canadian dollar. If we were back to a 90-cent Canadian dollar, nobody would worry very much about that competition.

Just what is it going to take to get back there?

Secretary BAKER. I think one thing it might take is better performance by the Canadian economy, Senator. The lack of appreciation of the Canadian dollar versus the U.S. dollar really reflects the market's assessment of the relative attractiveness of those currencies.

Senator EVANS. I'm sure it does. I guess that is what I am trying to get at.

How much jawboning can really change things when the fundamental market forces or basic economics are creating the imbalances in the first place?

Secretary BAKER. I cannot measure that for you.

All I can tell you is that I think we would be better off jawboning and trying to coordinate and cooperate than we are if we don't.

Senator EVANS. Oh, I agree.

Secretary BAKER. So, anything we get out of the enhanced surveillance process is going to be on the upside.

You know, the Canadians have a big fiscal deficit as well. They have something that I think is in excess of 6.2 percent.

Those are the kinds of things that would be looked at, in the surveillance exercise if you wanted to strengthen their currency.

Senator EVANS. Let me turn to another area.

We have suggested a good deal of advice to debtor nations, and you mention in your testimony on page 7 that special emphasis needs to be placed on measures to increase savings and investment, improve economic efficiency, and encourage a return of flight of capital.

Focusing on increased savings and investment, in your view, does the new tax reform proposal that has come out of the Senate Finance Committee move in the direction of encouraging or enhanc-

ing savings and investment? It eliminates IRA's, it eliminates capital gains and other tax benefits.

Secretary BAKER. I think it moves strongly in the area of encouraging increased investment for the principal reason that we are going to be freeing up so much capital for productive investment that has heretofore been going into shelters.

Senator EVANS. How about savings?

Secretary BAKER. I think that there will be an incentive for greater savings, notwithstanding the treatment that is accorded IRA's, Senator; but primarily as a consequence of the fact, simply, that you are getting rates down to a top rate on the individual side of 27 percent. If this bill were to pass intact, you would have 80 percent of all Americans paying a top rate of 15 percent or lower. That I think speaks for itself.

Therefore, I think there would be increased savings.

You know, the IRA has been there for 5 years. From some of the statements you hear, you would think it had been in place for 50 years.

The fact of the matter is, when you take the lower rates into consideration, I think people are still going to be better off. Something else that people have lost sight of, I think, is the fact that you are still going to be able to have the inside buildup of contributions to IRA accumulate tax-free.

Senator EVANS. Yes, I understand that.

So you are not worried that any other nation might, in looking our way during this jawboning process, suggest that we are not really moving in the savings and investment field ourselves?

Secretary BAKER. I do not believe so. I think we can rebut that pretty effectively.

Senator EVANS. Thank you.

Thank you, Mr. Chairman. I see the red light is on.

The CHAIRMAN. Thank you, Senator Evans.

Senator Dodd.

Senator DODD. Thank you, Mr. Chairman.

I welcome you here this morning, Mr. Secretary.

The Banking Committee Members, as well as the Finance Committee Members, had a chance to be with you during a joint hearing, so a lot of your testimony I have already had the pleasure of hearing.

Let me, if I could, though, just address a couple of points.

In a recent speech by the Assistant Secretary of the Treasury for International Affairs, Mr. Mulford was less than complimentary about the banking industry. He was speaking before the Bankers Association for Foreign Trade. He indicated the administration was less than pleased with the response of the banking community in playing its part in the Baker Plan, as it has been called—and I know you probably do not like that nomenclature, but, nonetheless, I think many of us agree that you are on the right track with this particular proposal—at any rate, that he was not happy with the banking community.

I wonder if you might break that down a little bit. I gather it is the smaller banks that are becoming more the problem, rather than the larger banks, in terms of their support for the thrust of your plan, at any rate.

Secretary BAKER. Senator Dodd, it is the smaller banks that have, quite understandably, in my view, always been the most reluctant to consider measures to make a bad credit a better credit, because they do not have the risk of loss that the larger banks have. The position they take, quite understandably, is that they don't want any more cheese; they just want out of the trap.

The Assistant Secretary is here and maybe I ought to let him answer this question, but I don't think that is really what he said.

What he said was that the banks have not developed the modalities or the mechanisms during this period, since October, that we would like to have seen them develop to be able to respond quickly when a debtor nation comes in and says we need new lending, that we are reforming, here is what we are doing, and now we need new lending.

They are still wrestling with the problem of what to do about the participant in the syndicate, let's say, to Equador, who has a $10,000 interest and is not really interested in going further.

Heretofore, in renegotiating these loans or coming up with new loans, the banks have always felt that everybody who participated in the original syndication ought to "belly up 'for their share of the new one.

I think what Mr. Mulford was pointing out was that we would have liked to have seen the banks come up with a mechanism in this intervening period. They have not done so.

Senator DODD. That may be a better way to describe it. I did not mean to suggest that you were attacking the banking community. But they are sort of lagging a bit on this.

Secretary BAKER. Yes.

Senator DODD. Do you still plan on going forward?

Secretary BAKER. Absolutely.

Senator Dodd. That is a crucial element in all of this.

Secretary Baker. It is, absolutely.

The banks have not said that they are unwilling to lend. Quite to the contrary, they have been very forthcoming.

As I indicated in my answer to Senator Kassebaum, U.S. banks with 96 percent of U.S. exposure in these countries have, in effect, signed a little pledge in writing saying we think this is the route to go and we will participate when the other elements of the proposal are being implemented—that is, reforms in the debtor nations and enhanced lending by the multilateral institutions.

Senator DODD. One of the problems as I see it—and please correct me if you think I am on the wrong track here—is that there are smaller banks, commercial banks involved. There is a problem, I would presume, to maintain their continued involvement, "bellying up to the bar," as you say. They just don't have the kind of assets, if you will, to be able to maintain the consistency and the longevity in the program.

There have been some suggestions made as to how we might keep some of those smaller or mid-sized banks involved in the process. One of them was to sell off some of the loans in the secondary market, these LDC loans in the secondary market.

The problem with that, as I see it—and others apparently have addressed this problem as well—is with our bank regulators. If they are selling off loans in their portfolios and are only getting 50

cents on the dollar, they are going to run smack into the problem of some of our own statutes here at home.

I wonder if you or your department has given any thought at all to either legislation or regulations that might allow for something as creative as that idea, to sell on the secondary market some of these loans, allowing some of these smaller banks to do exactly as you describe, to belly-up, so that you can maintain commercial bank involvement, crucial involvement, in your plan?

Secretary BAKER. Senator, it is my understanding that some of those sales are taking place; some banks have just decided they are going to sell their participations and have done so and taken the hit, whatever the hit is, to earnings.

When you say "smaller banks," I am assuming you mean smaller participants in the loan package.

Senator DODD. That's it, yes.

Secretary BAKER. Many of them have done just that and have done so under the current regulations.

Senator DODD. So you do not see a problem with the regulators?

Secretary BAKER. I really do not see that, no.

If it becomes one, I would simply say that we have discussed this overall problem with the regulators, and I think it is their view, without speaking for them, that they would not necessarily condemn new lending to a particular country just because the old loan was in any particular state of categorization, substandard, or what have you, if, indeed, reforms were being implemented.

Senator DODD. There are a number of countries around the world which are incredibly poor. I am thinking of such countries as those in sub-Saharan Africa. They are in such bad shape that they really do not have much of an economy at all, given recent climatic problems and the like.

Sub-Saharan Africa may be the most glaring group of nations that are just, by anyone's estimation, not capable at all of even remotely meeting their debt obligations.

There have been suggestions made that as a part of your plan, that this realization ought to be accepted, and allow either for cancellation or some program that would allow for these kinds of countries to be given relief and not expected to meet the same criteria that a higher income developing country faces.

I think it was the Institute for International Economics, I believe, that made the recent suggestion that we have to provide them with much easier terms or some period of absolute delay in any payments at all.

I do not see that specifically mentioned in your plan as you have outlined it here. Has any thought been given to that?

Secretary BAKER. Senator, I am familiar with that recommendation by the Institute.

Most of the lending to those countries is official lending. It is governmental lending.

Senator DODD. There is some commercial bank lending.

Secretary BAKER. There is some.

But the recommendation by the Institute speaks in terms of all lending, and the vast majority of lending to those countries are official flows.

We have, not only as a matter of policy but as a matter of law, restraints upon us with respect to forgiveness of those loans. For statutory reasons, we are simply not able to forgive them, even if we thought that was the best route to go. And we really do not think that is the best route.

Senator DODD. Was there any discussion of that in Tokyo at all?

Secretary BAKER. No.

The discussion in Tokyo with respect to the poorer countries of sub-Saharan Africa revolved around the structural adjustment facility, which will take the IMF Trust Fund reflows, put them with a roughly equivalent amount of World Bank money, and make that available on extremely concessionary terms to the poorest countries of sub-Saharan Africa, about $5 billion overall. This is an initiative the United States recommended, and it has been adopted by all the countries in that region.

In addition to that, as you know, the United States has been extremely liberal with respect to our bilateral assistance to a lot of these countries. Furthermore, we are participating to a modest degree in the sub-Saharan facility of the World Bank.

So, we have a lot of things going on with respect to those poorer countries.

We do not believe that the Institute's suggestion is one that should be adopted, from a policy standpoint; nor can it be adopted legally without some legislative change.

Senator DODD. Let me come back to some of those, if I can.

I commend you, by the way. I think they are on the right direction in this thing, going beyond just austerity means and growth and so forth. I hope some consideration will be given to the notion that some countries are going to have a hard time developing the kind of economy that we have; that a mixed economy in many nations is really what is necessary.

Secretary BAKER. Senator, I agree with that. If you will remember, the Program for Sustained Growth was outlined in Seoul with respect to the 15 principal debtor nations. We certainly understand the problems involved in and associated with growth-oriented economic reforms in some of the poorer countries of sub-Saharan Africa.

Senator DODD. Let me touch on Libya because I know terrorism was discussed as well at Tokyo.

There are United States oil companies still doing business in Libya. I wonder if that was raised at all by some of our allies there, as a point, maybe, that our businessmen are still doing business there. I know we have June 30 as a deadline, when they are expected to get out. But I wonder if there is any possibility that that date will be extended because of an inability of U.S. companies to sell off assets or the like there?

Secretary BAKER. No. 1, it was raised.

Two, in my opinion, the deadline will not be extended.

Three, the reason for the period of grace that we gave United States companies operating in Libya, as you know, was to prevent a windfall to the Qadhafi government, so that they would not simply have to walk away from those assets. They would be given a reasonable time in which to try to dispose of them.

Further, as you know, at the time we instituted these economic sanctions against Libya, we froze certain Libyan assets.

Senator DODD. I understood that. I was going to ask you what is the value of Libyan assets in United States banks in the United States? What is the value of assets frozen in branches of U.S. banks overseas? Do you know those numbers?

Secretary BAKER. I cannot split it up. I cannot break it out for you.

I really am not sure, either, that we have ever made public the total amount that we have. I would be delighted to give you the total amount figure privately, if it is not public. I do not believe it is public. I believe it is classified.

I would also get a breakdown for you and supply that to you if you want me to.

Senator DODD. What is the reason for not making it public?

Secretary BAKER. I don't know. We have just never put it out there.

My recollection is that it is classified.

Senator DODD. Who classified it? Why is that classified?

Secretary BAKER. I don't know. I can't answer that for you, to be very honest with you.

Senator DODD. There may be a very good reason. I don't know it, either. But I would like to know the reason.

Secretary BAKER. I'll find out.

Senator DODD. I was just told that the Iranian numbers were made public back during that crisis. They may have been leaked publicly. I don't know.

Anyway, could we get an answer?

Secretary BAKER. It is a healthy sum of money. I will get you the answer. If it is no longer classified, I will write you a letter that you can publish.

Senator DODD. Thank you.

[The information referred to is classified and retained in the files of the committee.]

Senator DODD. Mr. Chairman, may I ask unanimous consent to submit some additional questions in regard to the debt situation?

The CHAIRMAN. Without objection.

Senator DODD. I apologize. We have a Labor Committee hearing going on right now with a couple of votes coming up. So I will have to leave.

But I thank you very much, Mr. Secretary.

Secretary BAKER. Yes, sir.

Thank you, Senator Dodd.

The CHAIRMAN. Thank you, Senator Dodd.

Senator Kerry.

Senator KERRY. Thank you, Mr. Chairman.

I regret that I also am going to have to go to the other hearing. I have an amendment on the table right now which I need to go to speak to.

Mr. Secretary, before I go, I would like to commend you for your efforts with respect to the debt situation. I think it is a subject that we have not paid enough attention to.

I had wanted to discuss with you and perhaps elicit from you, first of all, your response to the Joint Economic Committee Report

of May 8 which, as you know, had some other views with respect to an approach. I was anxious to get your response to that.

I would like to ask if we could do that in writing

The CHAIRMAN. It is so ordered.

Senator KERRY. Mr. Chairman, I would like to submit some other questions that I had in writing. Particularly, I am interested in why we might not be proceeding along the lines, as in Peru and Nigeria, where we placed a cap with respect to the debt linked to trade balances. There seems to be a greater linkage effort with respect to some of the ifs that are part of your plan—the if growth continues at a certain rate, if there is a reform process, et cetera.

I worry that the increased indebtedness which we are going to create in the plan is not, perhaps, avoiding efforts that we might be able to make to try to deal with some of those ifs more concretely.

Secretary BAKER. I know you have to run, Senator, but, briefly, we could do that, we could take that approach.

In my view, that is not solving the debt problem but is basically declaring defeat and saying we are going to write this stuff off. The practical effect of such an action would be to shut down the country access to the private financial markets. There will be no further lending.

As I indicated in an earlier response to Senator Kassebaum that would probably be the case not only with respect to normal loans, but perhaps even trade credits and ordinary commercial credits.

So we could go that route, but we do not think that is the solution. We think the solution to the debt crisis generally is to try to encourage the adoption of these growth-oriented economic reforms that will permit these countries to find a way to grow their way out of debt.

We are not twisting any banks 'arms. If the banks do not want to lend the additional funds, if they do not see their credit being made a better credit, this bad debt that they have, then they will not lend any new money. And if they do not want to do that, that is their decision. It is not a governmental decision.

So we are not really compelling, if you will, the delivery of good money after bad.

Senator KERRY. I appreciate that.

I have just gotten a note that the committee is about to lose a quorum and they need me right now.

I would like very much to follow up on that, Mr. Chairman. If the record could remain open, I would like to submit some questions.

I thank you, Mr. Secretary.

The CHAIRMAN. Without objection, we will ask you, Secretary Baker, if you would respond to those questions.

Senator KERRY. Also, Mr. Chairman, may I have an opening statement placed in the record at the appropriate place?

The CHAIRMAN. Without objection, your statement will be placed in an appropriate place.

[The opening statement of Senator Kerry follows:]

OPENING STATEMENT OF SENATOR KERRY

Senator KERRY. Mr. Chairman, I welcome this hearing on the Latin debt crisis, the ramifications of which could spell very serious problems for the United States. Unfortunately, the debt problem has not received the attention it merits in a manner which would be conducive to its resolution.

I am pleased that Treasury Secretary James Baker is with us today. I want to commend you, Mr. Secretary, for the attention you have given to this problem. However, by the same token, I am wondering if the so-called Baker plan is a case of too little too late.

As I understand it, under the Baker plan the private and multilateral lending institutions are being encouraged to continue, or increase slightly, their international lending, as if the debt crisis could be solved by a new financial influx over and above the current levels of external debt. The plan also calls on major industrial nations to coordinate their decisions on exchange rates, as if the stablization of the international monetary system could be undertaken in the absence of involving the developing nations in these decisions.

The solution to the debt crisis is not a simple one. The crisis itself was the result of a complex process, and it calls for fresh and creative approaches in response.

I was struck by the conclusions of the Joint Economic Committee study released on May 8, 1986, which demonstrated how directly the debt crisis has affected America's farm exports, the debtor countries were forced to reduce grain imports, to increase their own food production, and in some instances, to export their surpluses. This resulted in a drop in American Food exports to the debtor countries, an increased competition of the Third World exports in traditional markets supplied by U.S. producers, and the fall of commodity prices, due to overproduction on a global scale.

The Joint Economic Committee study also evaluated the losses suffered by American manufacturers. The study found that more than 1 million American jobs had been lost because the debt crisis forced debtor nations to reduce their imports of U.S. products, which increasing their own exports of competing products to the United States.

In testimony before the Joint Economic Committee on June 17, 1985, Gerard Adams of the Wharton School stated that each dollar lost in American exports to Latin America represented a $3 loss in the gross national product of the United States. This multiplier effect on the U.S. trade deficit is a major concern as we analyze the impact of the debt crisis on our own economy. It illustrates the necessity for linking trade and financial policies in dealing with the debt problem.

The Joint Economic Committee study also pointed out that:

> In virtually all debtor nations, a typical IMF adjustment program calls on debtor nations governments to reduce domestic food subsidies, thereby, restricting domestic food consumption and contributing to the growing incidence of the malnutrition.

This is but another manifestation of the debt crisis and as such we must consider the social effects associated with the dismantling of the capital network and welfare institutions in developing countries—a dismantlement which has followed the orthodox IMF aus-

terity programs imposed on these nations. This has been a major bone of political contention in United States-Latin American relations. Indeed, we now face an institutional crisis, with the newly emerging and reemerging democracies in Latin America threatened by IMF austerity programs in exchange for short-term debt relief assistance.

The administration plan for dealing with this crisis maintains a case-by-case approach to debt renegotiations. The strategy of creating greater and greater indebtedness, piling loans on top of loans, and interest or more interest, may be a temporary solution to the balance of payment problem, but it is not a viable solution to the debt crisis.

The so-called Baker plan is conditioned on a long series of ifs—all of which must work in our favor if the play is to succeed. It could succeed:

If the developing nations implement growth-oriented reform;

If this reform really works;

If commercial banks provide adequate increases in new net lending to those nations which perform well;

If adjustments in trade are balanced; and

If disruptions do not occur over the time period in which the plan is taking effect.

I do not disagree with the necessity for an increased role for multilateral financial institutions such as the World Bank in promoting growth and economic reforms. I do not disagree that, considering the erosion of funding for these institutions, particularly under this administration, of the necessity for increasing their capital resources. This would make a clear statement of policy, and adopt tools adequate to deal on an urgent basis with the difficult issues of trade and finance posed by the debt crisis.

Mr. Secretary, I look forward to your testimony.

The CHAIRMAN. Secretary Baker, let me ask two more questions, one of which has to do with Argentina.

The first question arises from the World Bank approving a loan to Argentina last month conditioned on Argentina reducing its tax on agricultural exports.

As an interested member of the Agriculture Committee, when I visited Argentina, I found that, whereas in this country we are doing everything possible to move agricultural exports, in Argentina, people who had very rich soil and very good yields were being taxed even to get their exports out of the country.

Now it would appear that the World Bank is requiring Argentina to mitigate that process. Such action on the part of Argentina, of course, would ease, if not really initiate, a good number of agricultural exports they were not making already. These exports, unfortunately, are highly competitive with similar exports coming out of the United States. This has brought a number of questions from people in the wheat business and the corn business, in particular.

What comment could you make about this action, and how conceivably could this loan be in the interest of the United States?

Secretary BAKER. It is in the U.S. interest, Mr. Chairman, for these countries to continue to be able to trade with the United States, to receive U.S. products and goods. If one of their main export items is agricultural in nature, it is important that they be

able to sell those items overseas in order to buy manufactured items from the United States and other products from the United States.

So, generally speaking, to the extent that we can enhance growth and improve the economic prospects of nations that trade with us, it will be in our overall best interest.

This was a sectoral adjustment loan to Argentina, intended to assist it in making the transition, quite frankly, to more market oriented policies in its agricultural sector.

While it did encourage the abolition, as you point out, of that export tax, it also encouraged the elimination of certain subsidies that were being paid to agricultural producers in Argentina, which made them even more competitive with United States agricultural products and did so on a basis that we think was unfair.

That would be my answer to your question.

We vote consistently in multilateral institutions against project loans—as opposed to a loan that is designed to adjust an entire sector—for the production of commodities which are in surplus, and which, therefore, compete with the same commodities to the extent they are produced in the United States.

The CHAIRMAN. I think I can understand very well why we would be opposed to subsidies, and clearly you have been successful in getting this issue into the general international discussions. But in this particular instance, Argentina was obtaining revenue, which is important for its national fiscal policy. For us to intervene, as a part of the World Bank loan, to suggest that they eliminate a revenue producer to enhance, really, exports competitive with U.S. products, seems to me to be unreasonable.

I appreciate that overall we are trying to help out Argentina. But I think it is this kind of activity that leads to a considerable unease in the United States with the activities of the World Bank and the multinational banks.

For example, when we go out onto the floor of the Senate and encourage people to support these multinational institutions, as you have encouraged us to do today, we have a very, very tough time when our colleagues from the Corn Belt and from wheat farms point out this example of the bank deliberately attempting to create more competition in a market that is already glutted.

I think that program is obvious to you and you probably have given the best answer you can in a bad situation. This issue, I think, just needs to be highlighted for the benefit of our international colleagues in these situations. If they are looking to us for leadership, for sustenance, for whatever, they have to anticipate that when they intervene in such an instance, it makes things difficult for us. People in our country will object, and in this case they will object very strenuously.

Secretary BAKER. Senator, I do not disagree with that.

We are very sensitive to these types of loans.

I should point out that the proposal did not call simply for the elimination of the export tax, but for the substitution of a land tax. So there is still an impediment to that extent.

But I understand.

I suppose the only other thing I could say is that we have to look at these things in the overall context. Sometimes there will be

some element of a sectoral adjustment loan or even a structural adjustment loan, which could be criticized on the same basis that you have quite appropriately criticized this one.

The CHAIRMAN. My second queation follows up on Senator Kassebaum's line of reasoning based on that Joint Economic Committee report in which banks were found to be favored more than manufacturers and farmers.

Your answer was a reasonable one with regard to this issue, that in the event we get into substantial changes in the terms or writedowns of interest rates or similar actions, we may close the window for nations that need the cash.

On the other hand, it seems to me that reasonable observers in the agricultural and manufacturing sector would say that these large loan totals include many loans made by American banks and other banks who were not very prudent in making the loans. These observers might feel that there ought to be at least some consequence of making these imprudent loans, even though it is hard to segregate them from other loans.

I know that because our manufacturing and agricultural sectors have been hurting, there is understandable sensitivity about rescuing other sectors, namely the bankers, from the effects of their own folly. Therefore, the administration's emphatic discipline of the marketplace does not quite ring true if, in trying to preserve credit, we also preserve all of what appear to be imprudent loan arrangements. There is considerable sentiment among observers that we should require at least some writeoffs by the banks of their own mistakes.

To disaggregate the good from the bad I appreciate technically is a very difficult thing. But I understand the thrust of this criticism and I think it is an important one for everybody to appreciate.

Secretary BAKER. I understand that.

Let me just say, Mr. Chairman, that the point you just made was deliberated and debated at length internally when we were developing the Program for Sustained Growth with the help of the State Department, the Federal Reserve, and others.

I think that is a very, very valid point.

I think it was the view of all of us, however, that the net effect of requiring, in effect, some sort of penalty would be to foreclose access by these countries to the private financial markets. After all, this is not a bank bailout proposal. We are not promising implicitly or expressly any sort of Federal Government guarantee of additional new lending. We are not promising any World Bank guarantee. In fact, we have made it very clear to the banks that they should not be looking for World Bank guarantees coming out of this.

So what we are trying to do is to encourage the banks to look at these credits the same way they would look at a domestic credit that went bad. If there is a way to improve that credit through reforms the debtor will undertake, then the debtor needs to know that if he is going to undertake those reforms, there will be additional capital flows.

It is no different, in our view, from the situation that would pertain with respect to a bad domestic loan. We are not asking the

Congress for money to accomplish this. We are not offering the banks any sort of a bailout.

The CHAIRMAN. In essence you are offering them an invitation to continue in the game?

Secretary BAKER. Hopefully, we are trying to offer them some leadership with respect to a very, very difficult international problem and a problem that is of great significance we think to the United States.

One thing we might be able to provide here is some governmental leadership toward helping to accomplish or at least convince some of these major debtor nations that the way out is to adopt the same kinds of growth-oriented economic reforms that have brought prosperity to this country.

The CHAIRMAN. Senator Kassebaum.

Senator KASSEBAUM. Thank you, Mr. Chairman.

I would like to ask just a couple of specifics, if I might.

Under the plan, the commercial banks were to increase their lending by 3 percent?

Secretary BAKER. By 2.5 percent, I believe it is, Senator.

Senator KASSEBAUM. To which countries has this been done?

Secretary BAKER. Well, there have been no new commercial loans as yet. We think that there will be, as I indicated in my earlier remarks.

Senator KASSEBAUM. Why is this so? Is it because there have not been reforms yet sufficient enough to lend encouragement to the banks to increase their loans?

Secretary BAKER. Well, no country has gone to the banks as yet for new money. A number of countries are engaged in discussions now. Argentina, Mexico, Uruguay and a number of others. But as yet, there has not been any new commercial bank lending.

Senator KASSEBAUM. You did touch in your statement on some of the countries that were adopting policies consistent with the plan, out of the 15 developing countries addressed. I think you stated that the IMF has negotiations with about 11 countries underway.

Then you mentioned Argentina and Equador and the changes in policies that they are making.

I guess it takes a while to get all of these things in place. It has been some 7 months since at least this has been initiated in the public forum. I wonder what is the coalescing mechanism that sort of pulls all three of these things together—it seems to me the commercial banks and the multilateral lending agencies and the reform initiatives?

I mean, if I were a commercial bank, considering extending loans to Mexico at this point, with the large debt that they have, I would have some reservations—unless there is some ability to work out some rescheduling.

Again, it goes back to how these things all mesh together and what, out of these three things, it is, because it seems to me a lot of them are kind of on hold.

Secretary BAKER. There has been substantial progress I think made in increased multilateral development lending and lending of a structural adjustment nature, as opposed to just project loans or development loans.

Senator KASSEBAUM. Specifically where? Is Argentina one that you give as an example?

Secretary BAKER. There is one example.

Senator KASSEBAUM. Which, as the chairman points out, is not easy to sell.

Secretary BAKER. But there are quite a few others. I will supply you with a list of those.

[The information referred to appears in the appendix.]

Secretary BAKER. I mentioned some of the countries that were adopting these growth oriented economic reforms, but I am not sure I mentioned Colombia and Bolivia. Also there is Chile. Uruguay I think I mentioned, and also Brazil.

All of those countries are, in one form or another, and to different degrees, adopting the types of economic reforms that we are talking about. Many of them are, likewise, engaged in structural and sectoral loan negotiations with the bank.

So my point is that there has been better progress made on the multilateral side, than there has been so far with respect to the private commercial banks. But we are still quite optimistic that you will see that very shortly.

I mentioned in my statement that it will be less of a public process. No country likes to be seen as a guinea pig. Nobody wants to be the first country and nobody wants any suggestion that their economic policies are somehow going to be dictated by Uncle Sam.

Senator KASSEBAUM. Is the Treasury Department sort of the central coordinating mechanism in all of this, or do you work through the Federal Reserve and the World Bank and so forth that you mentioned?

Secretary BAKER. The IMF and the World Bank—well, more the IMF—still maintains its central role in the debt problem. The banks, of course, have the bank advisory committees.

Normally, the banks are not interested in negotiating with a country until that country has agreed to and adopted an IMF program.

As you quite rightly point out, it is not an easy thing to achieve procederally because it involves three different players—the debtor nations, the multilaterals, and the private banks.

Senator KASSEBAUM. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Kassebaum.

Senator Evans.

Senator EVANS. Perhaps the Philippines is the best of example of something, so let me focus on that one. We have concerns about repayment and at the same time, we are involved in a series of grant and concessional loan programs, under our foreign aid bill for the Philippines and perhaps for other countries as well.

Does it make much sense for us to continue to go on even a concessional loan program, when all we are doing is piling up interest repayments that now, in many countries, exceed the amount of aid we give them? They now have requirements to repay us more money each year than we provide them in new grants or new loans.

Secretary BAKER. That is true with respect to a number of countries, Senator. I think that is something which clearly you take

into consideration when you are considering the political interests of the United States.

That is more of a political question than it is an economic question.

We continue to make concessional grants. We continue to give foreign aid, if you will, to countries that have no reasonable prospect of repaying their indebtedness. But we do so on political grounds.

Senator EVANS. Isn't that part of our task, both the administration and Congress, particularly this Foreign Relations Committee, to try to bring the economic and the political back together?

Secretary BAKER. Yes, sir.

Senator EVANS. Would it be accurate to say, taking the Philippines as a good case, that it does not make any sense for us to offer concessional loans at this point, that we are better off to do whatever is necessary on a grant basis, until such time as their economy gets back to the point where they legitimately assume additional debt?

Secretary BAKER. Well, I'm not sure in this time of budgetary constraints that you could do it on a grant basis.

So I suppose one reason we do it on a concessional loan basis is because of the budgetary constraints.

Senator EVANS. I'm not so sure that we would not be as well off by a smaller amount of grant than a larger concessional loan which just puts them deeper in debt. Maybe they would be better off and we would be better off as well.

To what degree are we really attempting to look at that as an alternative?

Secretary BAKER. You are talking now about official lending, Government-to-Government, and we are not the lead agency with respect to that. But we do consult closely with the lead agency, and I think the primary problem there is strictly a budgetary one.

But the point you make is a good one because while we are not the lead agency, we hear from time to time, when we meet with representatives of those countries about the load that they have to carry by way of debt service. And a lot of those interest rates are rates that were considerably higher than current market rates because the loans were negotiated quite some time ago.

Senator EVANS. Should they have the same privilege of renegotiating those downward that the home mortgager does in this country?

Secretary BAKER. It seems reasonable to me that that should be the case.

Again, that is not something that the executive branch can do unilaterally, as I understand it. I think we need legislation to get that done.

We are frequently approached by some of these debtor nations.

Senator EVANS. If that is a good idea, if the administration thinks it would be a good idea, wouldn't it be appropriate to submit legislation to Congress?

Secretary BAKER. It might well be.

Again, it may well be that we do not have a consensus within the administration because of budgetary constraints. That is probably that is the impediment.

Senator EVANS. Even though you are not the prime agency, I am sure you do meet with and consult with the others who are prime agencies.

Is it your general advice, leaving politics aside, financially and economically that it might well make more sense to move in the direction of outright grants in limited cases?

Secretary BAKER. From a purely economic standpoint, I think so—if you segregate out the question of the hit to our budget that would be the result.

Senator EVANS. I have just one more question on current problems with the EEC.

The administration has said earlier, I think rightfully, that it is strongly in favor of an open trading system, one which expands the size of the whole international economic pie, rather than restricts it.

I am a little worried about what appear to be the ominous signs coming out of the EEC and our relationships with the EEC as they have added other countries to their community.

How serious are those problems and how readily do you think they can be worked out?

Secretary BAKER. I think they are very serious, Senator Evans.

As I indicated earlier, I thought it was a hopeful sign that we at least were willing to discuss agriculture at the Tokyo summit because, heretofore, we have never been able to get the EC countries to agree to a discussion of this issue.

Senator EVANS. That's a long way from any solution.

Secretary BAKER. It's a long way from a solution, but it is a necessary first step. You have to recognize the problem and sit down and be willing to discuss it before you can solve it.

I must say, however, that I think that the action the President has taken in calling for retaliation against the quotas that were imposed on our agricultural products as a result of the accession of Portugal to the EC is very clearly the right action.

It is our view that the action the EC took was GATT-illegal, and the President has pledged himself to aggressively enforce the trade laws of the United States and to adopt an aggressive posture in this respect. I, for one, was delighted to see that result from our interagency debate with respect to what we should do.

Now the question is what happens next. It is not unlikely that the EC will retaliate against us. I think we all ought to recognize—and this is the point you made—that retaliation is not necessarily cost free. But in this instance, I must say that I believe we were the aggrieved party, not the offending party, and the first step was taken by the EC and we have to stand up and let them understand that we are going to stand up for our own interest.

Senator EVANS. Is there any early indication of what next specific step the EEC might take?

Secretary BAKER. No.

There have been some discussions, general public discussions, to the effect that they are going to find some way to retaliate.

Senator EVANS. And then we retaliate in return, and they retaliate again.

Secretary BAKER. Then you get into that syndrome. Sometimes a trade war is winnable and sometimes it is not. But it really ought

never to be fought, to use a term that arises in another context from time to time.

Senator EVANS. I would agree. To use that same context, I hope that whatever trade war we are engaged in or about to be engaged in does not turn into a nuclear trade war between the EEC and the United States.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Evans.

I would like to ask Secretary Baker that he respond to questions from Senator Murkowski which he will submit in writing. He was unavoidably unable to attend the hearing this morning.

Secretary BAKER. Yes.

The CHAIRMAN. I will also ask that the record be held open for statements by other members and outside observers.

Finally, I just want to thank you again, Secretary Baker, Mr. Mulford, and others of your associates for the good work that you do all of the time and specifically for your appearance today. You have been most helpful to our own understanding of these complex issues.

Secretary BAKER. Thank you very much, Mr. Chairman.

The CHAIRMAN. This hearing is adjourned.

[Whereupon, at 11:11 a.m., the hearing was adjourned subject to call of the Chair.]

APPENDIX

PREPARED STATEMENT OF JAMES A. BAKER, III

Mr. Chairman, members of the Committee:

I am pleased to have the opportunity to brief you this morning on the principal economic developments at the Tokyo Summit and to bring you up to date on progress in implementing our international debt strategy. I would also like to urge your support for the important piece of legislation before the Congress authorizing U.S. participation in the Multilateral Investment Guarantee Agency.

The Setting: Progress and Opportunities

Allow me, before turning to these specific subjects, to describe the significant progress being made in establishing the fundamental conditions necessary to achieve and maintain a sound and growing world economy, more balanced trade positions, and greater exchange rate stability.

- o The Plaza Agreement last September has resulted in exchange rate relationships that better reflect underlying economic conditions. The Japanese yen and German mark have now appreciated more than 55 percent from their recent lows in February 1985. The dollar has more than fully offset its earlier appreciation against the yen; and it has reversed nearly three-quarters of its appreciation against the mark.

- o The Plaza Agreement also contributed to movement toward stronger, more balanced growth among the major industrial countries, including policy commitments to that end. Efforts to fulfill those undertakings are ongoing. The favorable economic convergence which was the focus of the Plaza Agreement is being realized,

with consequent narrowing of the "growth gap" between the U.S. and its major trading partners.

- o Inflation has been cut sharply and is expected to stay low, in part reflecting the effects of the sharp reduction in oil prices. This has facilitated a substantial reduction in interest rates and enhances prospects for further declines.

- o We now expect the deterioration in our trade position to halt this year, and we look forward to substantial improvement next year. Exchange rate changes take time to work their way through our economic system, as businesses and consumers gradually adjust their plans. Next year, as the impact of these changes is more fully felt, with assistance from the decline in oil prices, our trade and current account deficits should drop below $100 billion, or nearly one-third below our projections as recently as last autumn.

- o Preparations are well advanced for launching the new round of multilateral trade negotiations, with a Ministerial to be held this September. Our Summit partners agreed in Tokyo to the U.S. proposal that the new round should include services and trade related aspects of intellectual property rights and foreign direct investment.

- o And, as I will detail later, our proposals for improving growth in the debtor countries have gained wide support and are now being implemented.

Still, there is no doubt that problems remain and that we have to do more to address them.

The scars of a decade of economic turmoil are deep, and they cannot be easily or quickly erased. The distortions to our economies from the oil shocks, rapid inflation and the recessions of the 1970s and early 1980s have required us increasingly to address structural problems that demand time to correct. Unemployment remains high in many countries, and large domestic and external imbalances persist.

Uncertainties about the future behavior of exchange rates have also been prevalent, reflecting deficiencies in the international monetary system that gradually intensified over the years. We know also that the debt problems of the developing world, accumulated over a decade or more, cannot be resolved in a few short months. And we know protectionist pressures remain strong. We recognize the need to address related problems -- in our monetary system, in our arrangements for international economic cooperation, in the developing countries -- if we are to contain those pressures and work toward more open and fair markets.

The progress that has been achieved in the general economic environment, however, provides a golden opportunity to resolve these remaining problems. Success inspires confidence that we can go further. At the Tokyo Summit, President Reagan and the heads of the other major Free World democracies manifested the political will and leadership to confront the tasks that remain.

Strengthening International Economic Coordination at The Tokyo Economic Summit

The Plaza Agreement and subsequent coordinated interest rate reductions evidenced the willingness and ability of the major industrial countries to cooperate more closely on their economic policies. At the same time, experience of the past year demonstrated that exchange rate changes alone could not be relied upon to achieve the full magnitude of adjustments required in external positions. It had become increasingly apparent that closer coordination of economic policies will be required to achieve the stronger, more balanced growth and compatible policies necessary to reduce the large trade imbalances that remain and foster greater exchange rate stability.

For this purpose, we went to Tokyo seeking to build upon the framework embodied in the Plaza Agreement and to establish an improved process for achieving closer coordination of economic policies on an ongoing basis. I believe we succeeded.

The international monetary arrangements that have been in place since the early 1970s contain a number of positive elements, particularly a necessary flexibility to respond to economic shocks. However, this flexibility went too far, allowing problems to cumulate and countries to pursue policies without adequately considering the international dimensions of their decisions. The agreement reached at the Tokyo Summit seeks to combine needed flexibility with a greater likelihood that remedial action will be taken to deal with problems before they reach disruptive proportions.

The arrangements that were adopted involve a significant strengthening of international economic policy coordination aimed at promoting non-inflationary growth, adoption of market-oriented incentives for employment and investment, opening the trade and investment system, and fostering greater exchange rate stability. Details of the new procedures will, of course, have to be worked out in subsequent discussions. However, I see the enhanced surveillance process working as follows:

First, the measures for use in assessing country goals and performance will be agreed upon by the countries participating in the enhanced surveillance process. As stated in the Tokyo communique, a broad range of indicators would be utilized in order to achieve the comprehensive policy coverage necessary to insure that the underlying problems, not just the symptoms, are addressed. These

indicators would include growth rates, inflation rates, unemployment rates, fiscal deficits, current account and trade balances, interest rates, monetary growth rates, reserves, and exchange rates.

Second, each country will set forth its economic forecasts and objectives taking into account these indicators.

Third, the group would review, with the Managing Director of the International Monetary Fund, each country's forecasts to assess consistency, both internally and among countries. In this connection, exchange rates and current account and trade balances would be particularly important in evaluating the mutual consistency of individual country forecasts. Modifications would be considered as necessary to promote consistency.

Fourth, in the event of significant deviations in economic performance from an intended course, the group will use best efforts to reach understandings on appropriate remedial measures, focusing first and foremost on underlying policy fundamentals. Intervention in exchange markets could also occur when to do so would be helpful.

As you know, countries have been developing individual economic forecasts for years. Moreover, the IMF consults with individual countries on a regular basis regarding their economic policies and performance. What is new in the arrangements adopted in Tokyo is that the major industrial countries have agreed that their economic forecasts and objectives will be specified taking into account a broad range of indicators, and their internal consistency and external compatibility will be assessed. Moreover, if there are inconsistencies, efforts will be made to achieve necessary adjustments so that the forecasts and objectives of the key currency countries will mesh. Finally, if economic performance falls short of an intended course, it is explicitly agreed that countries will use their best efforts to reach understandings regarding appropriate corrective action.

The procedures for coordination of economic policy were further strengthened at the Summit. A new Group of Seven Finance Ministers, including Canada and Italy, was formed in recognition of the importance of their economies. At the same time, the Group of Five has agreed to enhance its multilateral surveillance activities.

In sum, Mr. Chairman, we have agreed on a more systematic approach to international economic policy coordination that incorporates a strengthened commitment to adjust economic policies. I am hopeful that the spirit of cooperation that made this agreement possible will carry over to its implementation. If so, we can look forward to greater exchange rate stability, enhanced prospects for growth, and more sustainable patterns of international trade.

International Trade at the Tokyo Economic Summit

Action toward closer international coordination of economic policies and greater exchange rate stability complements our efforts to promote a fair and open international trading system.

President Reagan and the others at the Tokyo Economic Summit reaffirmed their commitment to fighting protectionism and strengthening the international trading system. They further pledged to work at the September GATT Ministerial meeting to make decisive progress in launching the new round of multilateral trade negotiations. We expect this meeting will initiate these important negotiations.

As mentioned earlier, in the new round we will notably be seeking new GATT rules covering services, intellectual property protection, and international investment, as well as improved market access abroad. Agricultural issues are a priority for the U.S., and agriculture will also be included in the new round of trade negotiations.

The Tokyo Summit also featured a precedent-setting discussion of agricultural issues by the Heads of State and Government. The Summit gave special emphasis to concerns about the global structural surplus in some agricultural commodities that results in part from the subsidies and protection provided in all the Summit countries. Moreover, the Summit leaders agreed that policies should be redirected and the structure of agricultural production adjusted in the light of world demand. They also expressed their determination to support the work of the OECD in this area.

Open markets are essential to our overall international strategy of economic adjustment and policy coordination. In recommitting themselves to maintaining an open multilateral trading system, the leaders of the Free World's major industrialized nations recognized in Tokyo that:

- o Open markets promote economic growth world-wide. We have only to review the Depression years to see the effects of closed markets.

- o Open markets provide debtor nations with markets for their exports that are essential if they are to service their debt and, in turn, serve as markets for U.S. goods and products; and

- o Open markets facilitate our efforts to adjust large, unsustainable external imbalances among the industrial nations.

The Administration is committed to maintaining an open U.S. market and ensuring a free but fair international trading system. We must avoid passage of protectionist trade legislation that

would alienate our trading partners, encourage them to enact similar protectionist policies, and undermine the Administration's international economic policy. Closed markets and an atmosphere of confrontation would doom our efforts to solve our international economic problems in a responsible and constructive manner. The greatest threat today to economic well-being world-wide is the danger of protectionism and a trade war. We need your help to avoid these dangers. I urge you to give the Administration's policies a chance to work.

International Debt Strategy

The resolution of international debt problems is important to the U.S. economy as a whole, as well as to our international trade and financial system. We also have strong political and humanitarian interests in improving economic growth and political stability in the debtor nations.

When I briefed this Committee last October on our proposals for strengthening the international debt strategy, I warned that there are no easy solutions to the debt problem, and that the road ahead would be difficult and challenging. Seven months later, that statement remains valid. But I can also assure you that the directions in which we turned last fall are still correct and that we are making progress in implementing our initiative.

Recent improvements in the global economy are already making a significant contribution to developing nations' growth prospects and will substantially ease their debt service obligations. Stronger industrial country growth and lower inflation, for example, will add nearly $5 billion to developing nations' non-oil exports and reduce their import costs by approximately $4 billion this year. The sharp decline in interest rates since early 1985 will reduce their annual debt service payments by about $12 billion. The decline in oil prices will also save oil-importing developing nations an additional $14 billion annually.

At the same time, however, developing countries, particularly debtor nations, must position themselves to take advantage of these improvements by putting in place policies to assure stronger, sustained growth for their economies over the medium and longer term. As you know, the "Program for Sustained Growth" for the major debtor nations proposed by the U.S. in Seoul was premised on credible, growth-oriented economic reform by the debtor nations, supported by increased external financing.

In Tokyo, the Summit leaders welcomed the progress made in developing the cooperative debt strategy, in particular building on the United States' initiative. They emphasized that the role of the international financial institutions will continue to be central and welcomed moves for closer cooperation between the IMF and the World Bank, in particular. The debt initiative has also

received strong support from the international financial institutions, national banking groups in all major countries, and the OECD Ministers, as well as the key IMF and World Bank Committees representing both debtor and creditor countries.

The adoption of growth-oriented macroeconomic and structural policies by the debtor nations is at the heart of the strengthened debt strategy and crucial to sustained growth over the longer term. Special emphasis needs to be placed on measures to increase savings and investment, improve economic efficiency, and encourage a return of flight capital. A more favorable climate for direct foreign investment can be an important element of such an approach, helping to reverse recent declines in net direct investment flows. Such inflows are non-debt creating, provide greater protection against changes in the cost of borrowing, and can help improve technology and managerial expertise.

Similarly, a rationalization and liberalization of debtors' trade regimes can contribute to improved efficiency and productivity for the economy as a whole. Together with other growth-oriented measures to assure more market-related exchange rates and interest rates, to reduce fiscal deficits, to improve the efficiency of capital markets, and to rationalize the public sector, such measures can help improve growth prospects, restore confidence in debtor economies, and encourage the return of flight capital.

Such policy changes will take time to put in place and can't be expected to occur overnight. The process of implementing these reforms will also be much less public than the series of announcements to date supporting the debt initiative. Implementation will take place through individual debtors' negotiations with the IMF, the World Bank and the commercial banks. We expect these negotiations to place greater emphasis on dealing with current debt problems through a medium-term, growth-oriented policy framework. This process is already underway. The IMF, for example, has existing or pending arrangements with 11 of the 15 major debtor nations.

The World Bank is also moving ahead to strengthen procedures and policies to implement its expanded role in the debt strategy. It is currently assisting major debtors in the development of medium-term adjustment programs. It also plans to implement procedures which will streamline operations and provide for a more comprehensive review of lending priorities for individual countries. Finally, Bank staff are working with private creditors in considering ways to better mobilize additional support for debtors' adjustment programs.

The World Bank currently has structural or sector loan negotiations underway with 13 of the heavily indebted, middle income debtors. New structural or sectoral adjustment loans have already been signed with some of these countries, including

Ecuador and Argentina, both of which are also discussing follow-on standby programs with the IMF. Other countries are at different stages in implementing comprehensive growth-oriented economic programs.

As the Summit communique noted, sound adjustment programs will need to be supported by resumed commercial bank lending, flexibility in rescheduling debt, and appropriate access to export credits. Once debtor nations have designed economic reform programs to improve their growth prospects that have Fund and Bank support, it will be critical for the commercial banks to fulfill their pledges of financial support for these programs. The industrial nations must also cooperate regarding resumption of export credit cover to countries implementing appropriate adjustment policies.

In addition to the strong global support for our initiative with respect to the major debtors, we are also very pleased with the recent actions of the IMF and the World Bank on the Trust Fund initiative to assist low-income developing nations, primarily those in Sub-Saharan Africa. Creation of these new arrangements constitutes a major step forward in helping these countries address their fundamental economic problems. The new arrangements will also stimulate closer Fund/Bank cooperation and provide a positive context for current negotiations on IDA VIII. We look forward to their implementation so that a sound basis of growth can be established in these countries as well.

The Program for Sustained Growth is important because it touches on a wide range of U.S. interests, but paramount among these is its importance for U.S. trade. As you know, the debt crisis has had a direct impact on U.S. exports. U.S. exports to the 15 major debtor nations peaked at $40 billion in 1981. However, this reflected an international economic environment that was clearly not sustainable. Our exports to these countries fell sharply to $23 billion in 1983, as the debtor nations were unable to maintain previous import levels in the face of financial constraints and slower export growth.

The international debt strategy adopted in the wake of the debt crisis has helped to place the debtors' economies on a sounder footing and to permit a resumption of import growth at a more sustainable pace. U.S. exports to the major debtor nations have increased by 18%, or $4 billion, during the past two years and can be expected to improve further. The adoption of growth-oriented economic reforms, supported by increased financing from the international community, as envisaged by the debt initiative, will help to enhance both growth prospects and imports.

It will also be important, however, for the United States and other industrial nations to maintain open markets for LDC exports to permit them to earn the foreign exchange necessary to increase imports. The process of increasing growth and trade is an

interactive one. We cannot expect to reap the benefits of stronger growth and increased trade abroad if we close our markets at home.

Multilateral Investment Guarantee Agency (MIGA)

We believe prompt enactment of legislation enabling U.S. participation in the Multilateral Investment Guarantee Agency would make an important contribution to the implementation of our international debt strategy.

The MIGA is designed to encourage the flow of investment to and among developing countries by issuing guarantees against political risk, encouraging sound investment policies in member countries, and carrying out a wide range of promotional activities. The United States has long been an advocate of a greater role for foreign direct investment in the development process. Foreign direct investment both enhances the private sector's role in development and, as I earlier suggested, encourages the flow of non-debt capital to LDCs.

The MIGA will stimulate these flows and in addition, because of its multilateral nature, will be well positioned to promote investment policy reforms in developing countries. The United States has a direct stake in the investment policy reform process; since this country is the largest direct investor in other countries, it is in our best interests to see that appropriate investment protection standards are more widely accepted.

The Administration thus strongly supports U.S. membership in the Multilateral Investment Guarantee Agency and has requested Congress to authorize and provide full funding for membership in fiscal year 1987. The $222 million U.S. subscription to the MIGA involves only a $22 million budget outlay to be paid in cash. While another $22 million of budget authority has also been requested, it is not expected to result in any outlays and will be in the form of non-negotiable, non-interest-bearing promissory notes. The remaining $178 million is for callable capital under program limitations. The potential return on this small investment is, however, substantial. As the MIGA stimulates private investment flows to LDCs, this additional capital can, over time, substitute for scarce official flows from both governments and the multilateral development institutions.

The MIGA supports our development policies, reinforces our international debt strategy and will result in additional flows of direct investment to LDCs. In addition to the strong support of the Administration, MIGA has also attracted broad endorsement from the private sector. Both the Chamber of Commerce and the American Bar Association have issued statements in support of U.S. membership.

We should not allow delay in acting on the MIGA legislation to weaken the impetus behind MIGA. Many countries are moving expeditiously to take the necessary steps to join the agency. The United States, which has been a strong advocate of the MIGA and has taken an active role in ensuring that the agency created will be a sound and credible one, should now also take the steps necessary to join this important institution.

I strongly encourage prompt enactment of the legislation (S.2169) now before the Congress.

This legislation also contains authorization to merge the Ordinary Capital and Inter-Regional Capital accounts of the Inter-American Development Bank (IDB), which will allow more efficient use of Bank capital. In other words, the IDB will be able to lend on the basis of a smaller increment of capital subscriptions from members than if the two accounts were to remain separate. U.S. agreement to the proposal requires legislative action, and I urge your early and favorable consideration.

Multilateral Development Bank Replenishments

Mr. Chairman, currently we are negotiating replenishments with all of Multilateral Development Bank (MDB) groups. We have been consulting with members of Congress regularly to ensure that your views are taken into account. In conducting these negotiations we have -- per the President's budget request -- assumed that up to $1.4 billion in budget authority would be available in the out-years to fund these replenishments. The $1.4 billion amount maintains the budget authority level for the MDBs of previous years and reflects considerable inter-agency discussion, taking into account the impact of Gramm-Rudman-Hollings. The actual amount of each replenishment will be a function of how far an MDB goes in accepting the policy reforms we are seeking, e.g., improved loan quality, emphasis on privatization, and enhanced compatibility between MDB country strategies and individual loans.

We were very successful in achieving our objectives in the Asian Development Fund and agreed to a $3.6 billion replenishment over four years. The U.S. share remains at 16.23 percent, which means a contribution of $146 million per year. We are achieving a significant consensus among IDA Donors on U.S. policy objectives. Provided there is agreement to U.S. suggestions on policy reforms, the Administration is willing to support an IDA replenishment in the $10.5-$12 billion range.

Regarding the Inter-American Development Bank, we are in the midst of protracted and intense negotiations, including a meeting this week in Buenos Aires. It is still uncertain whether we will secure the reforms we seek, and as a result the role the IDB will play in the debt initiative has not been resolved. Discussions are just beginning in the African Development Bank, which we hope

to complete by the time of their Annual Meeting next year. We do not see the need for a World Bank General Capital Increase at this time. The World Bank has ample capacity to increase lending commitments by some $2-2.5 billion above the FY 1985 amount, and to concentrate that lending more heavily on the large debtors with credible reform programs.

I want to emphasize the Administration's commitment and full support for the MDBs. They play an important role in U.S. foreign and international economic policy. Now, we are asking them to take a more active part in supporting growth-oriented policy reform in the developing countries -- to play a central role in implementing the "Program for Sustained Growth."

I recognize fully that even in the best of circumstances supporting foreign assistance is never popular. Now, at a time of severe budget constraint, it will be even more difficult. However, of all the existing institutions, the MDBs are the most cost-effective from a U.S. budgetary perspective. One dollar of budget authority for the World Bank, for example, translates into $60 of lending authority.

Mr. Chairman, we can't duplicate that kind of leveraging on a bilateral basis. For instance, through 1984 the MDB hard loan windows have made total loan commitments of $133.1 billion at a cost to the United States of only $2.4 billion. The soft, concessional loan windows have made $50.6 billion in loan commitments at a cost to U.S. taxpayers of $14.8 billion.

The MDBs are also very effective at providing financial resources to countries of importance to us. For example, in FY 1984 total lending from the MDBs was $22.9 billion. Of this amount, $15.6 billion went to countries receiving U.S. foreign assistance and another $4.6 billion went to countries which are of strategic importance to us -- such as Mexico, Argentina, Brazil and Korea -- but which did not receive any bilateral assistance. In other words, nearly 88 percent of MDB lending went to countries of significant importance to the United States.

We need the MDBs as part of our international economic strategy. I strongly believe that if we do not support the MDBs now, we may have to resort to more costly measures later.

Conclusion

Mr. Chairman, the problems still with us in the international economic arena are substantial and difficult. But we now have the most favorable general economic environment in many years for making further large strides towards resolving them. The United States is leading the way in devising solutions in the best interest of both our own country and the community of nations. We believe the comprehensive, growth-oriented approach we have urged is the preferred path, and we are making real progress in implementing our strategy. I hope for your support in our efforts.

Senate Foreign Relations Committee

Statement in Support of S. 2169
Authorizing U. S. Participation in Multilateral Investment Guarantee Agency (MIGA)

Submitted
On Behalf of American Bar Association

By Timothy B. Atkeson, Esquire

May 20, 1986

Good morning. My name is Timothy B. Atkeson. I appear today on behalf of the Section of International Law and Practice of the American Bar Association. I participated in that Section's Task Force on the Multilateral Investment Guarantee Agency (which we refer to as "MIGA"). By the attached resolution of the ABA's House of Delegates (Annex A) the American Bar Association last February went on record as urging "the President of the United States to sign and ratify the Convention establishing the Multilateral Investment Guarantee Agency (MIGA) in a timely manner and the U. S. Congress to take appropriate legislative action to implement it."

We believe the United States should support MIGA for at least five reasons:

(i) It will facilitate the new emphasis on private investment the U. S. is seeking in the Baker Plan;

(ii) It is a very cost-effective use of our development dollars. For a $44 million appropriation we will get well over a billion in investment in the developing countries;

(iii) It will provide a useful multilateral agency spokesman, participated in by the developing countries, for the importance of a favorable investment climate to development;

(iv) It will get more countries into an active role in financing development projects; and

(v) It will fill gaps in coverage in existing national investment guarantee programs including our own OPIC program.

The United States joined in endorsing MIGA when the MIGA Convention was opened for signing and ratification at the World Bank Annual Meeting in Seoul last September. What we need now is early U. S. signature of the MIGA Convention, followed in due course by the necessary appropriation and legislative action. A number of developed countries, led by the United Kingdom, the Netherlands, and Italy, have signed and U. S. signature is needed to maintain the momentum of this process. Ten developing countries are parties. With such a substantial group of signatories, it should soon be possible to hold a preparatory meeting to draft MIGA's operating principles. We want the United States to be able to attend such a policy setting meeting.

The attached report to the ABA House of Delegates sets out our case for MIGA at greater length. The United States has an enormous stake in the protection of foreign investment from political risks and in the restoration of investment flows

to developing countries which are some of our very important trade partners. MIGA can play a very useful role in both respects. The American Bar Association strongly supports prompt action to bring about U. S. membership in MIGA. This means signature of the MIGA Convention now, participation in a preparatory meeting to get MIGA launched, and enactment of the necessary legislation this year.

Annex A

AMERICAN BAR ASSOCIATION

SECTION OF INTERNATIONAL LAW AND PRACTICE

REPORT

TO THE HOUSE OF DELEGATES

BE IT RESOLVED that the American Bar Association urge the President of the United States to sign and ratify the Convention Establishing the Multilateral Investment Guarantee Agency (MIGA) in a timely manner and the U.S. Congress to take appropriate legislative action to implement it.

REPORT

1. MIGA is an initiative of the International Bank for Reconstruction and Development (the "World Bank") an international financial institution, of which the United States is a member. It is designed to increase private foreign investment in developing countries and would be an autonomous agency with an organizational link to the World Bank. Upon initiation of operations, MIGA would issue guarantees, as well as co-insurance and reinsurance, against non-commercial risks for investments flowing from a developed member country into a developing member country.

2. The Convention has been approved by the Board of Governors of the World Bank and has been opened for signature of member governments of the World Bank. The United States Governor of the World Bank voted in favor of the Convention.

3. After the Convention has been signed by five developed countries (Category I) and fifteen developing countries (Category II), a Preparatory Committee of those signatory nations will be formed to begin the process of implementing the Convention, including preparing MIGA's operational and financial policies.

4. After being signed by member governments, the next step is ratification by those governments which choose full participation. It will become effective upon ratification by five Category I nations and fifteen Category II nations provided their combined capital contribution to MIGA is approximately $3€0,000,000. United States adherence to the Convention is a two-step process, that is, execution by the President and passage of necessary implementing legislation by Congress.

5. The objective of MIGA is to encourage the flow of resources to its developing member countries by issuing guarantees, coinsurance and reinsurance against non-commercial risks and by carrying out complementary activities such as the dissemination of information on investment opportunities. As such, MIGA is fully consistent with and supportive of the international investment policies of the capital exporting countries, including U.S. Government policy in support of an open international investment system in which participants respond to market forces, thereby promoting global economic development. The communique of last year's Seven-Nation Economic Summit Conference in London for example attaches "particular importance to . . . encouraging the flow of long-term direct investment."[1/] Accordingly, the seven Heads of State participating in the Summit Conference agreed "to work with the developing countries to encourage more openness towards private investment flows."[2/]

6. MIGA will stabilize investment conditions and enhance the Rule of Law with regard to private investment in the developing countries by cooperating with and complementing national, regional and private political risk insurance schemes for international investment, and by providing a procedure for orderly dispute resolution. Further, by giving developing countries a role in the protection of investment, MIGA promotes a spirit of shared interests between capital exporting and other countries, thereby creating the potential for more balanced host country laws and policies regarding investments. MIGA also provides a forum for discussion of investment issues and is empowered by Article 23 of the MIGA Convention to "promote and facilitate the conclusions of agreements, among its members, on the promotion and protection of investments." More specifically, MIGA will cover the same four broad categories of non-commercial risks sought to be protected by U.S. Government policy and law: a) the transfer risk resulting from host government restrictions on currency conversion and transfer; b) the risk of loss resulting from action by the host government which has the effect of depriving the investor of his ownership, control, or substantial benefit from his investment; c) the risk resulting from the repudiation of a contract by the host government when the investor has no access to a competent forum, faces unreasonable delays, or is unable to enforce a final judgment; and d) the war and civil disturbance risk.

1/ New York Times, June 10, 1984 at 14.
2/ Id.

7. Finally, MIGA provisions concerning dispute settlement encourage the peaceful resolution of investment disputes under, as is stated in the Preamble to the MIGA Convention, "fair and stable standards for the treatment of foreign investment." MIGA's provisions, which provide, under specified conditions, for submission to international arbitration of disputes between MIGA and a member country in relation to a claim acquired by subrogation, are fully consistent with established international practice which encourage resort to judicial or arbitral procedures and established U.S. Government policy that the treatment of foreign direct investment be subject to international law, including customary international law.

8. As stated in its Preamble, MIGA is designed to play an important role in the protection of foreign investment against "non-commercial risk", including expropriation. Article 11(a)(ii) of the MIGA Convention describes the coverage of "Expropriation and Similar Measures" in the following terms:

> Any legislative action or administrative action or omission attributable to the host government which has the effect of depriving the holder of a guarantee of his ownership or control of, or a substantial benefit from, his investment, with the exception of non-discriminatory measures of general application which governments normally take for the purpose of regulating economic activity in their territories.

This coverage is clearly intended to apply to any taking that would be regarded as an expropriation under international law. The distinction between such an expropriation and a regulatory measure is similar to that drawn in U.S. jurisprudence in determining whether there has been a taking requiring compensation for purposes of the Fifth and Fourteenth Amendments to the Constitution. MIGA will be responsible under its expropriation coverage, for example, if a host government subjects an investor's property to taxation, regulation, or other action that is confiscatory or that prevents, unreasonably interferes with, or unduly delays, effective enjoyment of the investor's property since these are not "non-discriminatory measures of general application which governments normally take for the purpose of regulating economic activity in their territories."[3/] This MIGA exclusion from expropriation coverage in Article 11(a)(ii) is similar to an exclusion from the definition of expropriation found in the United States Overseas Private Investment Corporation (OPIC) General Terms and Conditions.

9. The Commentary on the MIGA Convention confirms that the definition of expropriation coverage is not intended to prejudice investors' rights under international law to obtain compensation for an expropriation. In Section 14, the Commentary states:

3/ See, Restatement of Foreign Relations Law of the United States (Revised) (1985), Section 712, Comment g.

> In defining these measures, the Agency's practice would not be meant to prejudice the rights of a member country or of investors under bilateral investment treaties, other treaties and international law.

This language assures investors that MIGA will extend expropriation coverage to any loss deemed to be a taking under international law.

CONCLUSION

10. In summary, MIGA will aid in the development of the Rule of Law by providing a means for the resolution of investment disputes between developing country governments and investors from developed countries such as the United States. Clear contractual standards are imposed on potential disputants, who have agreed in advance upon a dispute resolution mechanism. The U.S. Government and its constituent agencies, including State, Treasury and OPIC, support the creation of MIGA and U.S. participation therein. The U.S. should become an early member of MIGA to assure strong U.S. influence and guidance in MIGA's critical organizational phase. Therefore the American Bar Association should urge the U.S. to enter into full and early participation in MIGA.

Respectfully submitted,

Arthur W. Rovine
Chairman
Section of International Law
and Practice

Draft submitted by Marcia A. Wiss
Chairperson, MIGA Task Force

World Bank
Non-Project Lending
October 1, 1985 - May 23, 1986

I: Structural Adj. Loans (SALs)

Country	Sector	Amount (millions of dollars)
Chile	SAL I	250.0
Malawi	SAL III	70.0
Burundi	SAL I	15.0
Niger	SAL I	60.0
Guinea	SAL I	42.0
Senegal	SAL I	64.0
	subtotal	501.0

II: Sector Loans

Ecuador	Agriculture	100.0
Hungary	Industry	100.0
Niger	Tranportation	15.0
Colombia	Trade/Agriculture	250.0
Argentina	Agriculture	350.0
Morocco	Education	150.0
Indonesia	Export Development	64.5
Pakistan	Export Development	70.0
Madagascar	Agriculture	53.0
Ghana	Industry	53.5
Colombia	Transportation	62.0
	subtotal	1,268.0
	Total	1,769.0

Source: Treasury Department

May 23, 1986

Responses of James A. Baker, III to Questions Asked by Senator Murkowski

Responses to BSA Questions

Question 1

Presidio, Texas is a border town of 5,000 persons of whom 3,000 are on some sort of welfare. Yet, Customs Commissioner von Raab testified before this committee that on the basis of cash flow, Presidio has the sixth largest bank in the state of Texas. As a native Texan with some knowledge of Texas banks, could the Secretary please explain to the Committee how a bank in Presidio, Texas could become the sixth largest bank in Texas without drug trafficking receipts making up the largest proportion of that cash flow?

Answer

The Commissioner's incorrect statement was based on a misinterpretation by a Customs field office of an analysis of data contained in Currency Transaction Reports (CTR) filed by 18 banks in Texas in 1982/83. It appears that data were erroneously extracted from a chart contained in the analysis.

Customs can provide clarification of the status of the First Presidio Bank.

- For the time period October 1984 through June 1985, First Presidio Bank filed 68 CTR's containing transactions totalling $1,451,585.

- There are two cities in the country of Presidio which have financial institutions:

  1) Marfa (which has one bank and one savings and loan)
  2) Presidio (which has one bank, First Presidio Bank)

- Deposit* figures as of June 30, 1985, for First Presidio Bank:

  1983 - 5,168,000
  1984 - 6,532,000
  1985 - 9,133,000

  * Deposits refer to the size of the bank on June 30th of year for total amount of money on account.

- Without detailed comparisons of population vs. bank activity and without familiarity with the economic situation of the area, the CTR activity appears to be relatively high for a town of the size of Presidio.

Question 2

Has the Comptrolier of the Currency reported to the Secretary on money laundering by Southwest banks and if so, what are the facts?

Answer

The Comptroller of the Currency, as regulator of the national banks, like the other Federal regulators of financial institutions, reports to Treasury whenever it uncovers possible violations of the Bank Secrecy Act. Quarterly, the Comptroller notifies the Treasury Department of possible violations of the Bank Secrecy Act. Where there appear to be willful violations of the Act, separate referrals are made to Treasury for the possible pursuit of civil or criminal penalties. Treasury generally sends the penalty referrals to the Internal Revenue Service Criminal Investigation Division for assessment of whether a criminal case should be pursued.

Since March 1985, the Comptroller of the Currency has forwarded a number of separate referrals on Texas and Oklahoma banks for possible violations of the Bank Secrecy Act. At the time of referrals, the Comptroller did not know whether any of these cases involved known "money laundering."

Question 3

What leverage through the Comptroller of the Currency does the Treasury have on money laundering by U.S. banks at home or abroad?

Answer

The Comptroller of the Currency has the power to charter, supervise, and regulate national banks, their subsidiaries and branches. Through the examination process, the banks' activities are reviewed. If any violations of law or "money laundering" were identified, they would be referred to Treasury or other appropriate law enforcement authority. The results of examinations are presented to the bank and its board of directors with directions to eliminate problems. Where the examination uncovers unsafe and unsound banking practices or violations of law, the Comptroller may take formal administrative action which includes, among other measures, issuance of cease and desist orders, removal of bank officers and directors, or assessment of civil money penalties. Where there has been failure to comply with the provisions of the Bank Secrecy Act, referrals for consideration of criminal or civil prosecution are made to Treasury or other appropriate law enforcement authorities and administrative actions to correct and eliminate the problems are taken. Because of the power of the Comptroller over national banks, the directions given to correct particular problems, especially when backed with the enforcement remedies, provide substantial leverage.

Question 4

The Committee has also heard testimony that Presidio is a way station and financial transaction point in the drug trafficking trade. Subsidiaries of U.S. banks make up the largest group of banks in Panama. What does the Secretary know of their potential role in money laundering of narcotics receipts and what leverage does the Comptroller of the Currency have over this alleged practice?

Answer

Treasury has information about a number of cases where drug receipts were laundered through Panamanian banks. Most do not involve United States owned banks. However, in the case of the notorious drug money launderer Ramon Milan-Rodriquez, some funds were laundered through Citibank in Panama. Milan-Rodriquez set up a number of accounts in various banks in Panama, including Citibank, in the name of bogus corporations. Citibank was used to a lesser extent by Milan-Rodriquez than a number of non-United States owned banks. He deposited cash he smuggled out of the United States for his some 1,000 drug trafficker clients into these accounts. He then had the money wired to his clients' accounts in the United States.

By his own admission, Milan-Rodriquez moved over a billion dollars for his clients over the course of seven to ten years. Milan-Rodriquez was arrested in May 1983 and sentenced in January 1986 to serve 35 years in prison and fined $6.49 million.

We currently have no means of compelling information about money laundering through Panamanian banks directly from the U.S. subsidiaries or through Panamanian authorities. The Comptroller attempts to work cooperatively with all foreign bank supervisors who must, of course, apply their own laws as to whether the Comptroller may examine subsidiary banks.

The Comptroller has no knowledge of any subsidiary of any United States bank participating in the laundering of narcotics receipts either here or abroad. If the Comptroller had such knowledge or knowledge of violations of laws, referrals would be made to the appropriate authority.

Question 5

What leverage does the Comptroller of the Currency have over foreign banks which operate both in Panama and in the United States?

Answer

Federal branches or agencies of foreign banks located in the U.S. and supervised by OCC are generally subject to the same rules, regulations, restrictions, and orders as national banks. However, at present, no Panamanian banks operate in the United States with a Federal charter.

MEXICO

Q1. In August of 1982, Mexico's foreign exchange reserves declined to $200 million, and the resulting problems set off the world debt crisis. What are Mexico's exchange reserves at the present moment and are they accumulating reserves or depleting them?

A1. According to Mexican data reported in the IMF's International Financial Statistics, total reserves (excluding gold) have grown from $834 million at end-1982 to $7272 million at end-1984 before falling to $4906 at end-1985. These grew to $5271 million at the end of January, 1986. These are the most recent public data.

Q2. In 1982, the Treasury Department used the Exchange Stabilization Fund to assist Mexico. Is the Fund still available should it be needed this summer?

A2. Short-term bridge financing from the Exchange Stabilization Fund continues to be an option for providing temporary liquidity where appropriate. It is premature, however, to speculate whether such a loan would be appropriate for Mexico.

Q3. Under what circumstances would appropriated funds have to be used to assist Mexico again?

A3. In the past, appropriated funds have not been used to assist Mexico, with the exception of oil purchases for the Strategic Petroleum Reserve. Other assistance has been in the form of short-term bridge financing and export credit guarantees from CCC and Eximbank. We have no plans for additional purchases for the SPR beyond the current fiscal year.

Q4. As part of the process of assisting Mexico in 1982, the Mexican Government made certain commitments to economic reform. Are they living up to their commitments now?

A4. Mexico's economy is quite complex and has undergone a number of changes since 1982. The situation today is quite different in the face of lower oil prices and revenues and a public sector that demands an increasing share of resources. Mexico did succeed in adjusting to the liquidity crunch of 1982/83. It still faces a number of difficult structural problems, including a large public sector deficit, mounting inflation, and a crowding out of the private sector. We believe Mexico will meet these challenges with the same courage and determination evidenced in the past.

Q5. Former Citibank Chairman Walter Wriston has estimated that $3 billion left Mexico in capital flight during the month of February alone. Given the record of capital flight and Administration testimony about pervasive corruption, what hope or guarantee would we have that more money loaned to Mexico would not end up in Geneva?

A5. As noted previously, the latest data on official reserves is for January. While definitive information is not yet available, indications are that Mexico's reserves continued to grow during the balance of the first quarter. It should be noted that there are extremely large amounts of money going into and out of Mexico all the time as a result of the high volume of bilateral trade and the integrated nature of our two economies in the border area. Obviously, the key to preventing capital flight is confidence. We believe the only way to assure confidence is as a consequence of a sound and credible program of economic adjustment supported by the IMF, IBRD, and the financial community. We believe that Mexico can and will put such a program in place shortly.

U.S. Debt Initiative and Trade

1. The Baker Plan envisions additional commercial bank and multilateral bank lending to the high debt countries in return for certain economic reforms. Since the only way these countries can repay additional debt is through trade surpluses, with whom could they be expected to run or increase existing trade surpluses?

Response:

The fundamental premise of the U.S. debt initiative is that stronger growth is essential to resolve the debt problem. In effect, debtor nations will have to increase their productive capacity and export earnings faster than they increase their debt. Nevertheless, they should still be able to significantly reduce their trade surpluses over the medium term even with modest net new lending by the multilateral development banks and the commercial banks.

First, interest rates have come down sharply over the past year and a half. This will substantially reduce annual interest payments on their debt, and therefore, the trade surpluses necessary to finance their debt service can be narrowed as well. Since 1984, interest rates have declined by about four percentage points, which will save the major debtors $11-12 billion annually.

Second, the adoption of economic reforms by the debtor nations will enhance their ability to attract foreign capital. In particular, the liberalization of investment regulations and financial markets and the maintenance of sound macro-economic policies should attract substantial flows of non-debt creating capital, including the repatriation of flight capital, foreign direct investment and portfolio investment. With these additional sources of foreign capital, debtors will be able to increase domestic production and imports.

Even though the $41 billion aggregate trade surplus of the major debtors in 1985 should narrow over the medium-term, their trade balance will still have to remain in surplus to finance their debt. Currency appreciation and stronger growth in Japan and Western Europe, however, should increase their demand for LDC exports, while U.S. goods should become more competitive relative to other industrial nations in debtor markets.

Impact on U.S. Producers

2. How would the Secretary answer the charge that the U.S. banks are being paid off at the expense of domestic exporters and import sensitive domestic industries?

Response:

Since the onset of the international debt problem, almost all troubled debtors have insisted on meeting the interest payments due on their debt in order to maintain access to international financial markets. If a debtor nation defaulted on its interest payments and therefore imposed a loss on its creditors, foreign creditors would be very unlikely to provide new lending, including short-term trade finance. Without new lending, troubled debtors would be unable to finance sustained growth and increases in U.S. imports. U.S. producers, therefore, benefit by debtor nations' efforts to maintain access to international finance.

While the imports of the major debtors, which had reached unsustainable levels in many countries, had to be cut during the initial stage of the international debt problem, these reductions would have been even greater if debtor nations had not continued to make their interest payments, thereby maintaining access to net new bank lending, and adopting appropriate policy reforms. Since 1983, moreover, major debtors' imports from the United States have increased by more than $4 billion, or about 18%, significantly faster than the 6% increase in total U.S. exports during the same 1983-85 period. Under the U.S. debt initiative announced by Secretary Baker last October, sustainable import levels will continue to increase as the debtor nations adopt growth-oriented reforms, supported by enhanced lending from commercial banks and international financial institutions. Achievement of sustainable 5% growth in the major debtors should help increase U.S. exports to the major debtors by another $8-9 billion by 1988.

Japanese Contribution to LDC Adjustment

3. Last week Japan announced a monthly trade surplus of $6.8 billion. During the month Japan's exports rose nearly 20 percent and imports actually fell 6 percent. What plan does the Secretary have to persuade Japan to accept some of the burden of adjustment by less developed countries?

Answer: Japan's trade and current account surpluses this year are running ahead of surpluses for the comparable period for 1985. However, on a volume basis, Japanese exports through May are down slightly (-0.6 percent) from the same period last year, while imports show a six percent increase in the same period. The fact that Japan's external surpluses have increased is due to price increases on the part of Japanese exporters, while the prices of raw materials, the bulk of Japan's imports, have declined.

The sharp appreciation of the yen since the fall of last year will contribute to a reduction in value terms in Japan's external surplus, but this adjustment will take time. Treasury agrees that Japan can and should do more to contribute to an orderly balance of payments adjustment on the part of the LDCs. We feel Japan should take steps to increase its rate of domestic economic growth, thereby contributing to greater import growth and a reduction in its surpluses with its trading partners.

We have initiated a process, the beginnings of which go back to the Plaza Agreement of September 1985, aimed at improving international economic policy coordination. A major step in this process was taken at the Tokyo Summit where the Summit countries agreed to a system of enhanced mutual surveillance designed to promote consistent domestic policies and compatible policies among countries.

So far as Japan is concerned, we will be looking very carefully at the GOJ's projections for its external accounts and domestic growth. We will through this process of intensified policy consultation urge the Japanese to adopt polices consistent with its role as a global economic and trading power.

RESPCNSES OF JAMES A. BAKER TO QUESTIONS ASKED BY SENATOR DODD

Senator Dodd

(1) A number of innovative suggestions have been made for handling the problem of smaller banks' unwillingness to participate in continued lending. One suggestion would take advantage of a secondary market for LDC loans which seems to have emerged over the past few years, to allow these banks to sell off their holdings in an orderly way. One of the problems with this approach appears to be U.S. bank regulators, who are likely to consider a bank's loan portfolio of less value if certain country loans it holds are selling for fifty cents on the dollar. Is there any way to make use of this type of scheme to deal with the smaller bank problem without impairing the loan portfolios of U.S. banks? Do bank regulators currently have sufficient statutory authority to deal with this issue in a more flexible way?

Response

There is sufficient flexibility in the existing regulatory treatment of loan sales and loan/loan swaps to deal with the concerns raised in your question. U.S. banks, especially regional banks, have been selling some of their LDC paper in the secondary market; frequently at a discount. Generally accepted accounting principles require that the bank record the transaction at the cash sale price. The balance of the bank's portfolio, however, does not need to be written down to reflect the discounted price as long as the bank has the ability and intent to hold the loans until their maturity. If, on the other hand, there is concern as to the ultimate collectibility of the loans in the portfolio, then the portfolio should be marked to market.

Obviously these guidelines are open to interpretation by individual regulators and bank accountants, some of whom would be more conservative than others. Moreover, the market is evolving and new issues surface frequently, thus requiring the regulatory agencies to continually review their guidelines in view of market dynamics. At the moment, I believe that the existing guidelines and regulations provide adequate flexibility.

Question on African Debt

Senator Dodd:

Over the past several years studies have been undertaken to make an assessment of the debt problems of African countries, particularly those in Sub-Saharan Africa. Many of these studies have concluded that it is unlikely for the foreseeable future that these countries will be able to make repayments. In that regard, what are your views on a recent suggestion by the Institute for International Economics that official creditors, such as the U.S., should cancel certain repayment obligations currently outstanding to these African countries and that the commercial banks should provide them with much easier terms on loans extended?

Response:

To begin with, even in Sub-Saharan Africa there is substantial diversity in individual countries' financial situations. There are a number of Sub-Saharan African countries which have not had to reschedule their debts, e.g., Mauritius, the Cameroons, and Botswana. Also, for those countries experiencing financial difficulties, the relative importance of creditors varies; in Nigeria, for example, commercial bank creditors play a major role. In other countries, e.g., Chad, most debt is owed to official creditors. All this points to the need to continue to deal with these problems on a case-by-case basis.

In this regard, the cancellation of repayment obligations to the U.S. Government would be neither appropriate nor useful. The only authority that currently exists in this respect allows the President to permit payments on AID loans to be retained in local currency for development purposes or to waive required interest payments or both. However, this authority is restricted to the "least developed countries" and the funds used for this purpose must be authorized and appropriated each year. It is highly likely, therefore, that funds appropriated for this purpose would be taken out of existing aid funding levels for the country and not represent net additions to the affected countries' financial flows. Many, if not most of these countries, already receive U.S. funds on a grant basis and at a time when budgetary constraints force difficult choices, it is more desirable that new AID finance for these countries be provided to support policy reform efforts, which are the key to the restoration of these countries' creditworthiness.

In addition, the amount of debt that would be potentially affected is relatively small. World Bank data show that for the Sub-Saharan African region as a whole the amount of disbursed debt consisting of bilaterial concessional loans (such as AID loans) was only 24 percent as of end-1983. Thus, a substantial part of the Sub-Saharan African countries' debts would be unaffected by this measure, even if widely used.

With respect to the terms of lending by commercial banks, this is an issue to be addressed by commercial bank creditors and African debtor countries. One can note, in this context, that the decline in interest rates has substantially reduced interest service owed on floating rate debt.

RESPONSES OF JAMES A. BAKER TO QUESTIONS ASKED BY SENATOR KERRY

Senator Kerry:

(1) The report of the Joint Economic Committee of the Congress, released in May 8, 1986, states that U.S. policies toward Latin American debtor nations have seriously hurt American farmers and manufacturers, without resolving the debt crisis. The study states that the only beneficiaries of the Administration's approach to the debt crisis have been banks and bank shareholders. The report states that: "The Reagan administration's management of the debt crisis has, in effect, rewarded the institutions that played a major role in precipitating the crisis, and penalized those sectors of the U.S. economy that played no role in causing the debt crisis." How do you respond to these charges?

Response:

During the initial phase of the Latin American debt problem, troubled debtors faced a liquidity crisis due to a combination of years of domestic mismanagement and a severe world economic recession. To save foreign exchange, imports, which in many countries had reached unsustainable levels, were cut. These reductions would have been even greater without the policy actions and continued commercial bank lending encouraged by the case-by-case international debt strategy. The U.S. debt initiative and a stronger global economic environment should support further increases in sustainable levels of U.S. exports to Latin America.

Since the onset of the international debt problem, almost all troubled debtors have insisted on meeting the interest payments due on their debt in order to maintain access to international financial markets. If a debtor nation defaulted on its interest payments and therefore imposed a loss on its creditors, foreign creditors would be very unlikely to provide new lending. Without continued access to international finance, sustained growth would be impossible.

While U.S. banks have not suffered large losses as result of the international debt problem, their improved performance since 1982 reflects primarily the strength of the U.S. economy and activities in other developing countries, not higher profits from lending to Latin America. Indeed, spreads on lending to developing countries have fallen by more than 40% since 1983.

Senator Kerry:

(2) The report of the Joint Economic Committee also states that, as a result of austerity measures imposed by the IMF, the World Bank and U.S. lenders, debtor nations have cut back on their purchases from the United States. The study also states that "Nearly 50% of the trade surplus that Latin America needed to pay interest was generated by reducing its purchases of U.S. products." The study also states that, since 1981, Latin American purchases of U.S. farm products have dropped from $6.9 billion to only $4.5 billion last year, and that Latin American exporters have taken away export markets from U.S. producers. Given these facts, how is the Baker plan contributing to a reduction of the trade deficit? How do you to propose to reverse the trends outlined above?

Response:

While Latin American imports, which had reached unsustainable levels in many countries, have been reduced, these reduction would have been much greater without the policy and measures continued commercial bank lending encouraged under the case-by-case international debt strategy. Due in large part to the success of the international debt strategy, since 1983, Latin American imports from the United States increased by about $5 billion or over 20%, significantly faster than the 6% increase in total U.S. exports during the same 1983 to 1985 period.

Under the U.S. debt initiative, sustainable import levels will continue to increase as debtor nations implement growth-oriented reforms, which should benefit U.S. exporters. U.S. exports to Latin America are estimated to increase by a further $6 1/2 billion by 1988. Moreover, trade and investment liberalization are key elements of these economic reforms, which should benefit U.S. firms in terms of more open markets. At the same time, these reforms will increase the efficiency of debtor economies and improve their creditworthiness, thereby providing the necessary support for continued, sustained increases in purchases of U.S. goods and services.

Senator Kerry:

(3) Economist Robert J. Samuelson wrote in the Washington Post of March 26 that "The United States should push banks for write-downs: reductions in loan amounts and an easing of interest rates. Our long-term national interest and the stability of the banking system lie in making the debt burden tolerable. Piling new loans atop the old makes all the debt more risky. By raising the debt burden, it erodes debtors' political will to pay at all. Yet, Treasury Secretary James A. Baker III's debt plan, intended to spur higher economic growth, calls for more loans and not write-downs."

"No one denies that the major banks would suffer temporarily. But they would survive. A 20% write-down of all Latin loans would reduce the capital of the nine largest U.S. banks (with more than half the loans) by about 25%. The bankers' complaints that poor economic policies caused the current crisis are self-serving and hypocritical. If the policies were so obviously misguided, why did banks lend in the first place?" In fact, the banks' loans abetted these policies. Banks that make poor loans should not escape the consequences of their mistakes."

Please comment on Samuelson's statement, and on his proposal for a 20% write-off of all Latin loans by major U.S. banks.

Response

I do not support the proposal for a 20 percent write-off of all Latin loans by major U.S. banks, nor do I believe it is necessary or desirable. Its impact would be counter-productive.

U.S. commercial banks' claims on Latin America and the Caribbean nations (excluding offshore banking centers) are $83 billion. Total claims on these countries by all commercial banks in the BIS area are about $249 billion. Thus, U.S. bank claims on average are 33 percent of the total.

The suggestion of a write-off presumably applies to all U.S. banks involved. The nine largest held 64 percent ($53 billion) of the U.S. claims; the next 15 largest banks report 18 percent of the claims ($15 billion); the 171 remaining U.S. banks that report also have 18 percent ($15 billion) of the U.S. claims on these borrowers.

A 20 percent write-off of exposure to these countries by the nine largest banks would be equal to $10.6 billion. That, indeed, would reduce these banks' capital by 25 percent.

Although the impact would vary bank by bank, such a drastic action generally would sharply reduce income or cause actual losses, cause banks' stock prices to plummet, force them to reduce other domestic and international loans, and potentially cause major upheavals in interbank markets. Banks are interdependent; generalized write-offs of that magnitude would seriously damage confidence in the U.S. banking system.

Note, however, that the nine largest banks hold 21 percent of the Latin debtor countries total banking debt. A $10.6 billion (20 percent) write-off of their exposure is equal to only four percent of the debtors' total commercial bank exposure and would save about only 4 percent of Latin American debtor's annual interest payments. In contrast, the decline in interest rates since 1984 has resulted in a 36 percent savings on their annual interest payments.

Who would benefit? Debtor countries to some modest extent would be relieved of the pressure to adjust and adopt their own economies to the changing realities of the international economy. The proposal is generalized and makes no distinction among countries. The benefits are applied indiscriminately, without regard to need or performance. Debtor countries don't need this form of extreme relief. The foreign exchange savings at the expense of U.S. banks and shareholders would enable the borrowers to more easily pay off the foreign creditor banks that hold 2/3 of the claims, strengthening our competitors' banking systems, economies and shareholders postions while weakening our own.

The cost to the U.S. economy would be slower growth, reduced employment, higher interest rates, reduced profits and taxes (and a resulting increase in the Federal deficit) and an incredibly unfair discrimination against U.S. banks and domestic borrowers, including those in the troubled energy and agricultural sectors. I do not believe this is a proposal that should be taken seriously by the U.S. Senate.

Banks that make poor loans will not escape the consequences, but often the mistakes are not only theirs. In addition, the international economic environment, disinflation, and changes in commodity prices are variables that cannot always be easily predicted, but which can impact a borrower's ability to repay debt on schedule.

It may well be that regulatory agencies will mandate reserves on some existing debt that have the effect of reducing bank capital; they have done so in the past. This is a last resort and something done on a selective basis. Such actions have been applied to countries that have failed to adopt adjustment programs and failed to work successfully to restore creditworthiness. Such write-downs are not in the countries' best interests, but are required for sound supervisory and prudential reasons. They are a warning, there is a stigma attached. Banks

become unwilling to lend new funds. This certainly is not the desired way to resolve a debt problem.

There are far better alternatives. Recall the main points of the Program for Sustained Growth. I have called on the international banking system to increase lending by about 2 1/2 to 3 percent annually to those countries that are making meaningful adjustment efforts. My view is that moderate new lending in support of adjustment program can improve, rather than weaken, the quality of outstanding bank credits. This point has been acknowledged repeatedly by U.S. regulatory agencies since 1983. Such lending usually is done in connection with adjustment programs and loans supervised by the IMF, IBRD and other MDBs. The major industrial countries though sound macroeconomic policies leading to lower interest rates and inflation also are making a major contribution.

Senator Kerry

(4) What, in your opinion, would be the impact on the U.S. banking system, and the U.S. economy, of a default by Mexico on its $97 billion external debt? Do you believe that such a default is possible or likely in the forseeable future?

Response

I do not believe that Mexico intends to default on its external debt, either to the United States or to other international creditors. I believe the $97 billion external debt figure you cite approximates total Mexican debt to all external creditors. Mexico currently owes international banks in the BIS area $71 billion, of which $25 billion to U.S. commerical banks. The U.S. share of commercial banking claims is 35 percent.

In the conversations I have had with senior Mexican officials, they have indicated that they want to repay their debt. They understand the importance of restoring their creditworthiness and very much want to avoid a default scenario. They want to work their way out of the current difficulties that face them.

Thus it is highly improbable that Mexico would deliberately default on its debt or that Mexico would not attempt to service its debt in the foreseeable future. A default, as you know, can (but need not) occur when a borrower fails to meet a contractual agreement. What usually happens in such situations in domestic markets is that the banks work with their troubled clients to extend maturities, swap debt for equity, reduce interest rates, and establish multi-year rescheduling arrangements to help the borrower through a troubled period. Banks do this because it is in their own self-interest. By restoring the strength of the borrower, they improve the quality of their assets.

The current international debt situation, taken country by country, is not much different. It is in the banks' own self-interest to work with the borrower. Indeed, because of the number of banks involved internationally from so many creditor countries, a great deal more is at stake because we share the same interdependent international financial and economic systems.

Debtor countries too realize their own stake in the system. We are not speaking in any sense of a repudiation scenario which would bring to a halt international trade and commerce with a country that takes such an action. What we have seen since 1982 has been a series of ad hoc moratoria, restructurings, multi-year rescheduling agreements and adjustment programs that have also involved new lending from the international financial community, including the private commercial banks, international financial institutions such as the IMF and IBRD and government lending institutions.

As long as restructurings, reschedulings and work out situations are taking place in connection with adjustment programs in the borrowing country, the underlying situation is strengthened rather than weakened. There already have been situations in which LDC debtor countries have been unable to meet contractual payments on schedule and where loans have gone into non-accrual situations; banks have reduced income, increased bad debt reserves, made write-downs, and reduced new lending to the countries concerned. But in most cases the countries and lenders involved have worked together to redress the situation. There has been considerable progress. At no time has the safety and soundness of the U.S. or international banking system been at risk.

There are bound to be hiccups and selective difficulties in the future, but as long as these are handled with good will and in a cooperative spirit by all the major parties, there need not be a negative impact on either the U.S. or international banking systems nor on the U.S. or international economy.

As a final note, U.S. banks have been improving their capital position steadily since the emergence of the debt crisis, and this is to be desired. That said, an objective of the Program for Sustained Growth is to assure that adequate commercial bank lending will be available to support the adjustment programs and measures taken by the troubled debtors in connection with IMF and IBRD adjustment programs and loans. The international banking community has pledged to do its part.

Senator Kerry:

(5) Banker Felix Rohatyn has proposed a plan in which current interest rates to Latin American countries would be cut by 4 percentage points, saving them $15 billion annually. To compensate for losses by the U.S. banks, he proposes a guarantee of the banks' loans by either the United States or the World Bank. He also suggests that Japan add $100 billion in new capital over 5 years, funneled through the World Bank and the Inter-American Development Bank. Together with $75 billion in interest-rate relief, this would be a total aid package of $175 billion in new capital, or $35 billion annually, as compared to $10 billion under the Baker plan. Please comment on the Rohatyn plan. Is this a feasible approach to the debt crisis, in your opinion?

Response:

I don't believe that Mr. Rohatyn's proposal is a feasible approach to the international debt problem.

Any plan that proposes that the United States government "bail-out" commercial banks and developing country debtors by giving banks guarantees on their debt and forgiving a substantial portion of interest due on U.S. government credits is unacceptable. The federal government has no responsiblity to guarantee the financial obligations between private financial institutions and developing country creditors. During this period of heightened budget-restraint, this type of plan that would be extremely costly to the federal government is especially inappropriate.

This proposal would also be counterproductive to Latin America's efforts to achieve sustained growth and to restore their creditworthiness. By mandating that banks receive less than market interest rates on their loans, Mr. Rohatyn's plan unilaterally imposes large losses on the banks. As you know our banks are already facing strains caused by the problems in agricultural, energy and real estate sectors.

In these circumstances, banks and other financial institutions would be very unlikely to provide new lending to Latin America. Trade and other commercial credits would also dry up. While the interest savings would be beneficial to Latin America in the short term, the consequent loss of access to international finance would seriously damage their growth prospects for many years. Other developing countries might also be penalized, based on a perception of higher risk on loans to developiong countries generally.

Rather than forcing their banks to charge less than market interest rates or to give guarantees, the appropriate role for creditor governments in the international debt strategy is to continue to support debtors efforts by promoting a stronger global economic environment. These efforts are currently helping

to ease substantially the debt burdens of the developing countries. For example, since 1984 interest rates have declined by more than the four percentage points called for by Mr. Rohatyn's proposal. Banks have also narrowed their spreads by 40%. As a result, LDC debtors have enjoyed a 5 percentage point decline in interest rates and spreads, which translates into a $12.5 billion annual interest payment savings for Latin America.

The $15 billion savings mentioned in the question is possible only if official creditors, including the U.S. government and the World Bank, also unilaterally reduce their interest rates. This obviously would be unacceptable to the U.S., and impossible for the World Bank, as it would result in large losses and, therefore, the loss of its preferred status in international capital markets. Without this preferred status, the World Bank would be unable to provide longer-term relatively low interest rate credits that developing countries need.

Finally, the World Bank does not presently need a large infusion of new capital. The World Bank currently has ample capacity to increase annual lending commitments and to concentrate that lending more heavily on the large problem debtors with credible reforms. Moreover, Japan would not be likely to provide additional capital to the World Bank unless it was in the context of a capital increase in which other members would also contribute or where Japan would receive increased shares in the World Bank. The World Bank, however, as explained above, does not currently need a General Capital Increase, and it is doubtful whether other members of the World Bank would be willing to relinquish their shares.

Senator John Kerry:

6. You stated in the hearing of the Senate Foreign Relations Committee on May 20 that you were opposed to the concept of a cap of debt service payments tied to a percentage of export earnings, such as has been adopted by Peru and Nigeria, because this would lead to a writing-off of the debt, and admitting defeat. Isn't such a solution, coupled with a rescheduling of the debt, the only way to ultimately avoid a default in many cases? Does the Administration plan to take any retaliatory measures against Peru or Nigeria?

Response

Imposing caps on debt service payments would cut off debtor countries' access to the international capital markets, at a time when net new money is vital to support their efforts to adopt the growth-oriented economic policies essential to resolve their debt problems.

The Administration does not plan to "retaliate" against Peru or Nigeria. However, in so far as ceilings on debt service payments cause debtor nations not to service fully their external obligations over an extended period of time, this would lead to a loss of income by the banks, thus causing many of them to reduce exposure and perhaps future lending to entities in those countries. Moreover, the regulators, of course, would have to adopt a posture in keeping with prudent management of the banks' assets and desire ultimately to be repaid.

Senator John Kerry:

7. Prof. Eduardo Aydos, a legislative fellow on my staff this year, has developed an alternative proposal for dealing with the debt crisis, which is attached. Please review and comment on this proposal.

Response

In an intricate proposal, Professor Aydos suggests a debt service payments benchmark equal to 20 percent of export earnings. Countries running large trade surpluses would be required to use a higher proportion of their export earnings for debt service payments, while poorer countries running large trade deficits would have up to 40% of their debt service automatically rescheduled. Interest on deferred or rescheduled debt service would be paid by industrial countries proportionate to the trade benefits they gain, possibly through the imposition of an import tax.

Application of these concepts provides an incentive for the debtor countries to increase imports, perhaps beyond levels which would be either prudent or sustainable. In addition, individual countries' net trade balances will be importantly affected by their debt service requirements. In this regard, trade surpluses, rather than deficits, are generally highly desirable policy goals since they serve to reduce a country's external borrowing, thus hastening reestablishment of its creditworthiness.

Furthermore, the proposal would effectively tax consumers in the industrial countries who are not responsible for this debt and should not bear responsibility for its repayment.

Finally, this proposal represents a major departure from our current case-by-case debt initiative to resolve the debt problem through sustained growth. It would reduce pressures on countries to put their own house in order, which is key to eventual resolution to this problem.

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